AN ASSESSMENT AND RATING OF THE BULGARIAN BANKING SYSTEM

Produced by:	**For:**
Michael Borish and Company, Inc.	**United States Agency for International Development**
137 Howick Street	**NDK Office Building**
Rockcliffe, Ontario K1M 0G9	**Bulgaria Square, 1**
Canada	**1463 Sofia, Bulgaria**

date: July 6, 2001

Table of Contents

Page

I. Introduction 1

II. Methodology of the Rating System 1

III. The Bulgaria Rating 3
A. Section 1: Assessment of Financial Sector Infrastructure 6
B. Section 2: Assessment of Economic and Structural Factors 12
C. Section 3: Assessment of Banking Structure and System Profile 18
D. Section 4: Assessment of Banking Sector Development Based on Prudential Norms 23

ANNEX 1: The Bank Rating System 27

ANNEX 2: A Detailed Assessment of the Bulgarian Banking System 32

ANNEX 3: Comparison with Poland and Romania 116

ANNEX 4: List of Contacts 127

ANNEX 5: Bibliography 130

AN ASSESSMENT AND RATING OF THE BULGARIAN BANKING SYSTEM: 2001

I. Introduction

The following assessment of the Bulgarian banking system has been produced under contract to the United States Agency for International Development/Bulgaria by Michael Borish and Company, Inc. Michael Borish and Company, Inc. would like to thank Debra McFarland (USAID/Bulgaria Mission Director), William Foerderer, Rayna Dimitrova, David Lieberman, Ivanka Tzankova and Nora Ovcharova of USAID/Bulgaria for their kind support and guidance. Michael Borish and Company, Inc. would also like to thank the many people who provided time and documentation for this assessment to be carried out with effectiveness. A list of the people with whom the team met is found in Annex 5. Michael Borish visited Bulgaria from April 29-May 11, 2001, in conjunction with this project.

The banking sector assessment is an update from an earlier assessment conducted in early 1998, shortly after the introduction of the currency board arrangement and major new legislation and regulations for the banking sector. This update is different from the one conducted in 1998 in that it has substantially more information (due to increased availability of information in Bulgaria), and it includes a comparative annex (see Annex 3) with banking sector indicators in Romania and Poland. These two countries were selected for ease of relative peer comparability with Romania (e.g., second-tier EU accession country, relatively late reformer), and similarities in many banking sector reform approaches with the more advanced Poland (e.g., substantial investment in banking supervision development, movement from a fairly insular approach to foreign investment to a more open environment).

In addition, the banking sector assessment (along with inputs from many other firms) is being used by USAID as part of its strategic planning exercise for the next three-five years of assistance. It should be noted that the work conducted by Michael Borish and Company, Inc. in this regard is based strictly on the firm's own assessment of developments in Bulgaria, and does not in any way bind USAID to those recommendations. A separate document related to USAID projects, performance indicators and recommendations can be found in a separate volume entitled "Considerations for USAID Financial Sector Assistance to Bulgaria: 2002-2006".

II. Methodology of the Banking Sector Assessment Rating System

The rating system utilized to assess the banking sector of Bulgaria is based on a review of more than 200 issues and topics that have been used to construct a diagnostic methodology for the review of banking systems. This tool has been utilized by USAID in other transition economies, and is applicable to virtually all banking sectors in the world.

In its simplest form, the rating system is focused on four general areas of activity—based on 28 "sub-categories," and subject to five general classifications. The activities and sub-categories include the following:

USAID Banking Sector Rating System Activities	
General Areas of Activity	***Sub-Categories***
Financial Sector Infrastructure	• General policy and system • Legal framework • Regulatory and supervisory capacity • Payments systems • Accounting framework • Rating agencies • Financial media • Professional associations • Academic institutions • Miscellaneous areas relevant to financial sector infrastructure—telecommunications, postal, safekeeping
Economic Factors and Indicators	• General trends • Private sector development issues • Monetary and related savings and credit matters • Fiscal considerations • Exchange rates • Balance of payments issues
Banking Structure and System Profile	• Overview of the system and financial measures • Profile of ownership structures • Governance and management issues • Non-bank competition
Banking Sector Development Based on Prudential Norms	• Capital adequacy • Asset quality • Management capacity • Earnings • Liquidity • Operating environment • Transparency and disclosure • Sensitivity to market risks

The following classifications are utilized to provide a scoring for the individual issues assessed, as well as in developing a composite rating for the banking sector as a whole. Annex 1 provides greater descriptive detail about how the ratings apply by sub-category. Essentially, the methodology matches the description of the rating for each of the 28 sub-categories, assigns a rating for each, synthesizes the collection of ratings by each of the four areas of activity, and then ultimately arrives at a composite rating for the country. No effort is made to weight individual variables, or to quantify ratings along mathematical lines. Rather, 28 major sub-categories of the four main groupings are all rated within the five-point rating system, with allowances for pluses and minuses in the event that the direct numerical classification does not fully match with performance. The evaluation is both qualitative based on trends and assessments, and quantitative to the extent the figures are useful and meaningful. In the case of Bulgaria, the ratings by each sub-category also take into account trends from the 1998 assessment.

USAID Banking Sector Rating System Scoring Description	
5	Outstanding; world class; state-of-the-art; best practices; virtually no serious systemic risks
4	Solid; strong; satisfactory; competitive; few systemic risks or problems, and those are manageable
3	Adequate; favorable trend; improvement needed; potential for major systemic risks
2	Inadequate; weak; significant improvements needed; major potential for destabilization via systemic risks
1	Dismal; monopolist; resistant to competition and change; no confidence; widespread corruption; weak institutions

It can be noted that the current assessment is far more comprehensive than the earlier one conducted in 1998. This has much to do with greater availability of useful information, the willingness of bankers to speak more freely about their problems and challenges, and the achievement of macroeconomic and banking stabilization that was only partly in place in early 1998. At the time, most major banks were still state-owned, and financial information was weak. By early 2001, financial and statistical information are still not strong, but they are vastly improved and more openly available than in 1998. In particular, the banking sector and the Bulgarian National Bank (BNB) have established web sites that disseminate useful information about the financial condition of banking institutions. Several web sites also convey the impressions of bank management on market developments.

III. The Bulgaria Rating

The composite score awarded for 2001 (based on 2000 data plus trends into 2001) in Bulgaria is **3**, as compared with **2+/3-** in 1998. The improved rating reflects modest progress in most areas evaluated, and impressive progress in a few areas. Most important is the achievement of macroeconomic and banking sector stability, which now presents an opportunity for banks to move on to the next stage of intermediation and risk assumption. Specific to the banking sector, them most impressive accomplishment has been strategic privatization, which is expected to professionalize banking standards, governance and management and enhance system competitiveness. Based prudential norms, virtually all categories showed equal or improved performance (i.e., capital, asset quality, liquidity, operating environment, transparency, sensitivity to market risk), with the only weakness being in the unimpressive level of earnings. From a macroeconomic and structural standpoint, the economy has shown improvement in terms of real growth, monetary and fiscal discipline, and the balance of payments. The private sector now plays a more prominent role in the economy. As for financial sector infrastructure, modest progress was noted in the legal framework and role of associations. BNB’s supervision department continues to make progress.

Negatives and weaknesses specific to the financial sector that prevent a higher rating include many of the banking sector aggregates (i.e., size of assets/deposits/capital, lending to the real sector, number of banks with limited lending authority and product offerings) and still under-developed non-bank financial services. These weaknesses are compounded by inefficient and unproductive methods of privatization in the enterprise sector, continued weak information and data on borrower credit worthiness, judicial enforcement of creditor claims when borrowers default. The absence of an adequate bank resolution framework, and currently untested risk management systems at many banks will also present a challenge as lending and risk profiles increase. Thus, as of summer 2001, the assessment of the Bulgarian banking system is as follows:

The Bulgarian Banking System—Summer, 2001	**<u>Composite Score: 3</u> (as compared with 2+/3- in 1998)**
The Bulgarian banking system has undergone considerable transformation since economic collapse in 1996-early 1997. The authorities initiated major changes in the legal and regulatory framework in 1997-98, introducing a currency board, stabilizing macroeconomic fundamentals, and putting the banking system on a privatization track based on open markets and the attraction of strategic foreign investment. These objectives have been achieved, an impressive accomplishment in light of economic collapse four years ago. From a macroeconomic standpoint, the authorities have been effective in maintaining monetary stability and achieving near fiscal balance. Gross foreign exchange reserves now provide significantly greater import cover than in 1996, largely on the strength of rising exports and steady increases in foreign direct investment. In terms of banking, Bulgaria has privatized five of the six major banks slated for privatization, and only four state banks remain. The five banks privatized since 1998 include Bulgaria's two largest, both of which were privatized via strategic investment from EU member state banks. In effect, Bulgaria shifted ownership of the banking system from 82 percent state ownership of assets in 1996 to 80 percent private ownership by end 2000. While lending to the real sector is still low at 12.5 percent of 2000 GDP, it is poised for growth now that strategic investors are in the market, IT and MIS are coming on stream, margins have shrunk in the corporate sector, and banks are seeking higher returns. In addition, Bulgaria has introduced a deposit insurance scheme that provides modest coverage (up to 6,900 leva), and has already administered two failed bank deposit payouts without any noticeable panic in the marketplace. Recognition of Bulgaria's accomplishments has manifested itself in an invitation from the European Union in December 1999 to commence formal negotiations for entry into the EU. This has been followed by a steady increase in trade with the EU and other advanced countries, along with increasing regional trade with other EU aspirants (CEFTA and others). Notwithstanding Bulgaria's accomplishments, several weaknesses and problems remain. The legal and institutional framework remains weak, particularly in the judiciary. Accounting, statistics and financial information are inadequate and incomplete. There is limited infrastructural capacity in terms of credit information for more systematic and precise risk classification of borrowers prior to lending. The absence of an effective bank resolution framework is unfortunate, and will need to be remedied if Bulgaria is to manage the failed bank process in a more systematic, transparent and predictable way. Many Group IV banks appear limited in terms of what they can offer in terms of size, and a few are reported to be weak and/or engaging in financial practices of questionable legality or prudence. The non-bank sector remains weak and underdeveloped. Earnings in the banking sector are unimpressive and insufficient for the needed investments for modern banking systems and technologies. In the real sector, accounting standards are poor, projects are often infeasible, financial requests are often predicated on excess leverage, and disclosure practices of companies undermine confidence in credit quality. At the structural level, privatization by management-employee buyout or mass privatization via vouchers has not produced adequate incentives for improved performance and enhanced credit worthiness. The conclusion is that conditions have improved since 1997-98, and the authorities are to be commended for following sound policies in support of stabilization, market discipline, and strategic privatization. This has been combined with some notable progress in terms of institutional capacity, namely banking supervision. However, many banks and regulators are untested in new and more complex areas of risk that are likely to be present in the market in the coming years. Intermediation levels can be expected to increase, particularly in the consumer/retail market. With increased lending and risk will come losses and some measure of consolidation. The net effect will be positive, although the market, the public, and the supervisory authorities will need to contend with higher degrees of	

volatility than they have encountered in the last three-four years.

- **The banking system is now majority private and foreign-owned**—all but four banks are private; foreign banks account for 75 percent of total assets; state banks only account for 20 percent of assets
- **There is still high concentration** in Bulbank (foreign trade bank) and DSK (local currency household deposits), but concentration is diminishing with competition
- **There are 35 banks in Bulgaria, and increased competition should eventually trigger consolidation**—mainly of the Group IV banks are small and limited in terms of what they will be able to provide to the marketplace as the larger banks penetrate the retail market and offer a broader spectrum of products and services
- **Total assets of banking system are less than $5 billion** (average assets approximate $133 million per bank)—most banks are small
- **Total deposits are less than $3.4 billion** (average deposits are less than $100 million per bank), even though deposits account for nearly 80 percent of total funding
- **Banks have high levels of regulatory capital, but are small in terms of aggregate capital**—CARs are 35.6 percent, but total capital is only $656 million ($24 million on average)
- **Asset quality has improved**—standards loans are 92 percent of total; loss loans are only 3.4 percent of total
- **Lending to the real sector is low, at 12.5 percent of 2000 GDP, but expected to increase in the coming years**—banks have stayed away from lending to companies and households in recent years if borrowers and their projects have not complied with banks' underwriting standards; now that conditions are more stable and real GDP growth is expected to continue in the 5-6 percent, there are better prospects for lending on the condition that enterprises and households provide better documentation and projects for financing; banks are expected to make an aggressive push into retail banking once systems are in place, market research is finalized, and personnel are trained
- **Earnings are unimpressive, narrow in sources, and predicated on negative real rates paid on deposits**—banks earned a total of $133 million in 2000, only $4 million per bank
- **ROE (20 percent) and ROA (3 percent) are acceptable for now, but will come under pressure when competition heats up**—the earnings base is currently too small for these returns to be considered sufficient
- **Most banks have excessively high levels of overhead**—there are 21,000 bank employees (600 on average), but some of the traditional banks have much higher staffing than is needed; this will continue to serve as a drag on earnings, while other banks rely increasingly on improved IT and systems for more efficient service delivery and operational control
- **Management capacity is still variable, and risk management systems are largely untested in Bulgaria**—banks are only now beginning to assume risk in lending and related activities; the majority of earning assets are still in low-risk investments, mainly in offshore banks that require minimal risk management capacity
- **Banks have high liquidity ratios**—this reflects banks' aversion to lending in an environment that has been less than conducive until recently, and is driven by banks' investment in safe securities on top of prudent regulatory requirements
- **There is limited market risk in Bulgaria**—banks' capital and liquidity ratios are high, exposures are generally within limits, and mismatches in exchange rates, interest rate features, or maturities are not considered so broad as to put the system at risk
- **Bulgaria has weathered political risk well in the last few years, suffering less from contagion effects than other emerging markets**—the currency board and strict prudential framework for banking has insulated the system from much of the volatility that has affected other markets in recent years

The basis for the composite is described by each of the four general activities and the 28 sub-categories below. A detailed assessment is attached as Annex 2. Readers are encouraged to read through Annex 2 for supporting information and data to justify the findings and ratings applied.

Section 1: Assessment of Financial Sector Infrastructure

***I. Financial Sector Infrastructure : Score: 3** (vs. 3- in 1998)*

Bulgaria has made progress in advancing its financial sector infrastructure since 1997, and the invitation to join formal negotiations for accession to the European Union should keep the reform effort on track. However, much progress has gotten bogged down in the difficulties of implementation.

General policy has been supportive of a market-based system since after the collapse of 1996. This has been evidenced by the willingness of the authorities to permit strategic foreign investors to obtain a collective majority stake in the banking system. By contrast, the government could have embarked on costly restructuring exercises to strengthen domestic banks before the entry of larger foreign banks. That it did not reflects policy supportive of increasing integration with Europe at the expense of protection for uncompetitive domestic financial institutions.

Laws are comprehensive for banking, although there are still shortcomings that are being addressed in the insurance sector. There is also a gap in terms of an effective and modern bank resolution framework linked to the ongoing viability of the deposit insurance fund. However, most of the problems in the legal domain relate to court capacity, the absence of precedent consistent with market practices, the traditional anti-creditor bias of many judges, and general judicial capacity weaknesses.

The regulatory framework is firm for banking, although it is less settled in the insurance sector. Weaknesses in banking supervision include the need for more advanced early warning systems, improved reports from the banks, and additional training needs for supervisory staff in new risks that are likely to emerge as the system becomes more competitive and complex. However, for now, the Banking Supervision Department (BSD) has made substantial progress since 1997, and it is viewed as adequate relative to the risks being assumed by the banks at the moment. However, as noted, these are expected to become more challenging in the coming years, and BSD systems and staff will need to adapt. This is considered far more problematic and challenging in the insurance sector, where institutional capacity lags that established in banking.

Accounting and financial information remain relatively weak in Bulgaria, although bankers have managed to adapt credit risk evaluation methods to the environment to reduce the level of non-performing loans. Meanwhile, external auditors have managed to help the banks improve their information systems, and to comply with regulatory standards and reporting requirements. However, the profession has many gaps in it, not the least of which is the small number of chartered accountants in IAS and auditors in ISA. Most registered firms still follow tax-oriented practices, and many bankers are still unable to lend (even when they know a firm is a good credit risk) because of the violation of underwriting standards that would ensue.

Otherwise, developments are fairly positive. Bulgaria is moving to Real Time Gross Settlement in 2002. While the BNB credit registry is not as comprehensive as bankers would like, they do use it. This is an advance from 1997-98 when the system did not even exist. Private rating agencies have rated a handful of banks and insurance companies, and this may increase in the coming

	years if Bulgaria is successful with structural reform. The financial media appear reasonable, and many regulators and market players have web sites to broaden public disclosure of information. There are several active associations that are playing a constructive role in legislative/regulatory reform and policy discussion. Improvements in telecommunications are making it possible to move on with needed modernization of MIS, IT, and electronic banking.

***1.1. Policy and System: Score: 3+** (vs. 3 in 1998)*

Bulgaria showed significant progress in 1997 after economic collapse in 1996. **Policy has been geared to stabilizing the macroeconomic framework**, with evidence of this in the form of relatively low inflation rates (notwithstanding the 2000 increase), fiscal discipline, satisfactory levels of foreign exchange reserves to sustain the currency board arrangement, and responsible debt management that has maintained international confidence in the underlying economy. The proof of this confidence is in the relative lack of concern about problems in Turkey spreading to Bulgaria (apart from a potential minor change in export earnings), which differs substantially from the contagion effects that have affected investor sentiment in other emerging markets.

Nonetheless, while the previous government was committed to establishing an environment conducive to market development (with partial success), **it was not as successful in implementing structural reforms in the real sector**. Numerous problems have surfaced in the realm of privatization and corporate governance. In the financial sector, judicial capacity weaknesses have been exposed with regard to bank resolution, while accounting and financial information weaknesses persist due to poor (and manual) internal systems, fragmented intra-bank reporting, and lack of experience with risk-based management reports. In general, there is a view that government policy is undermined by weak information, a lack of depth in understanding the complexity of financial sector issues, and relatively thin capacity below senior levels in the implementation of new laws and regulations. Overall, there is a sense that reforms are reactive, causing significant cost and burden to the system, undermining needed certainty for investment, and generally lacking in medium-term vision. The recently elected government faces the challenge of reversing these trends.

In addition, **Bulgaria faces the challenge of correcting structural imperfections. This can be done with time, particularly if there is a cohesive strategy that more effectively harmonizes the legal, tax and institutional framework for modern financial services**. In general, government policy has been supportive of development of a market-based system since 1997. The invitation to enter negotiations for EU membership will help to consolidate gains, and provide incentives for difficult decisions that will need to be made in the coming years.

***1.2. Legal: Score: 3** (vs. 3- in 1998)*

Major financial sector legislative reform was achieved in 1997 and has been broadly sustained. There are few reported problems associated with banking and insurance legislation by industry practitioners themselves. However, there have been problems and weaknesses associated with the regulatory/supervisory process (in insurance, which is underdeveloped compared to banking) and with judicial processes.

Banking legislation is broadly viewed as effective, although there will be calls for increasing permission from the regulatory authorities to permit banks to enter non-bank

activities. This will have to proceed cautiously, although banks with demonstrated capacity and competence from more developed markets should clearly be permitted to move forward in these fields. In the insurance sector, legislation is evolving in line with EU standards.

Insurance sector legislation and regulatory capacity have much further to go in terms of capacity building and implementation as compared with banking. In some ways, permission for banks to enter insurance needs to be pursued cautiously to allow the regulatory authorities to develop the capacity and systems for an orderly insurance market to function.

Meanwhile, **bank resolution represents a critical weakness in the legal framework**. There have been bank closures, but 10 failed banks remain to be definitively resolved. Bank bankruptcy is a court-oriented process in Bulgaria, and is often protracted due to the role of judges and trustees in the process. This often is time-consuming, costly, and of questionable effectiveness with regard to the liquidation of assets. Recent efforts to reform this process stalled in parliament and eventually did not pass. A more efficient, transparent process for bank resolution will need to be in place as a future contingency.

Other changes have recently been adopted, most notably improvements in the Civil Procedure Code to strengthen creditors' rights, mainly in the area of collateral collection. However, here as well, there are problems associated with control of collateral resting with the debtor during periods of dispute, as well as problems related to perfection of liens on securities as pledge registration requirements pertain to the holder of the securities rather than the securities themselves.

There are also concerns about the frequency of amendments and changes to laws, as frequent legal changes can reduce certainty needed for investment and risk-taking. However, in fairness to the previous government, changes in legislation have often resulted from consultations with and recommendations from market players. This is partly driven by EU accession criteria and the greater sense of urgency the government now places on complying with EU directives.

***1.3. Regulatory and Supervisory: Score: 3** (vs. 3- in 1998)*

The laws on BNB and banks have provided for a tightly regulated banking environment to guide Bulgaria through its stabilization process following the events of 1996. BNB has a clear mandate to license, regulate and supervise banks, and it has acted on this mandate since 1997. However, bankers criticize the process as being excessively rules-based, heavily data-oriented, and sometimes inefficient because of the lack of harmonization of regulatory reporting requirements with existing internal systems. In some cases, the communications process has been criticized as being deficient, tardy and incomplete. Given the frequency of regulatory changes, this is disruptive and costly to bank operations. Nonetheless, net of these kinds of criticisms, the banks appear to recognize the strong mandate BNB has to supervise the system.

The Law on Banks is explicit and clear in spelling out requirements of banks within the regulatory framework. Moving forward, **the challenges faced by BNB and Bulgaria's banks relate to moving from a narrow, risk-averse focus on stabilization to a system that is more competitive, generally privately-owned, and driven by the need to generate stronger and more diverse earnings streams for better returns**. With several large foreign banks now present in Bulgaria, competition has already begun in the small corporate sector. Most banks are now embarking on development of retail strategies, including movement towards packages and more complex instruments that have the potential to generate far higher earnings. On the other hand, several banks (among them smaller and largely domestic banks) may be lagging the more dynamic banks in terms of investment in new technologies, development of more suitable MIS, and general market experience. This presents the risk that smaller banks may not be able to compete, or that the less competitive banks may seek to generate higher earnings predicated on strategies that are excessively risky and dangerous. At a minimum, **consolidation can be expected as market development proceeds**. Should this occur, Bulgaria will need to move forward with a more appropriate resolution strategy that is fast, least cost, and consistent with rapid deposit payout.

Beyond that, **banking supervision will need to strengthen its early warning systems** to ensure that issues of adverse selection or large concentrations in the inter-bank market do not undermine general system stability. **Many banks will need to further improve their governance, including internal audit, and general management capacity**.

***1.4. Payments System: Score: 3+** (same as in 1998)*

The Law on the Bulgarian National Bank states that "establishment and functioning of efficient payment mechanisms" is a function of BNB's main task, which is currency stability. Investment in this area as far back as 1992 to protect BNB from unintended overdraft credit and to provide low cost and prompt settlement indicates that Bulgarian banking and monetary authorities appreciate the importance of the payments system to economic stability. There were no major problems reported with the payment and settlement system as is, even though it is not designed to handle large value payments, settlement sometimes takes as long as three days, and banks do not know their exact balances until 10:00 a.m.

More recently, the government decided to accelerate movement towards Real Time Gross Settlement (RTGS) to come closer to meeting EU criteria for eventual monetary union. RTGS is expected to be achieved by mid-2002, and this will provide a number of benefits to the system, including opportunities for more electronic applications of banking (e.g., electronic signatures, e-commerce, internet banking) and more efficient liquidity management.

***1.5. Accounting: Score: 3-** (vs. 2+/3- in 1998)*

Accounting standards have improved in the financial sector, although it remains a broad weakness in the real sector. Accounting in the enterprise sector is still driven by tax considerations, and is generally not used as a tool of financial management and planning. Meanwhile, the accounting and audit profession counts only a small fraction of total practitioners as licensed in IAS/ISA. This is beginning to change, but Bulgaria lacks overall accounting capacity for modern business management.

The move to IAS for bank *annual* reports began in 1997, mainly for the state banks to be privatized. IAS was also required for large enterprises slated for privatization. For banks, the role of the external auditor is formally incorporated into banking legislation. This has been used to identify internal audit, systems and technology needs, along with management standards for their operation. **Based on findings from on-site examinations, most banks have begun to make improvements. However, many of the smaller banks still lack what is needed in terms of information systems**. In some cases, this has to do with human error resulting from manual processing. In other cases, it is due to poor reporting forms, fragmented data processing systems, and overstretched management.

International accounting firms have been involved in assisting Bulgarian authorities in modernizing standards. However, applying IAS in a meaningful way at the structural level for useful management purposes continues to take time, and this has been one of the areas where Bulgaria has not made as rapid progress as is needed. **The prime-rated foreign banks have no problems with these issues. However, some of the Group IV domestic banks are reported to**

have weaknesses in these areas. There may also be related problems at some of the remaining domestic banks with large branch networks that rely on manual bookkeeping.

1.6. Rating Agencies: Score: 2+/3- (same as in 1998)

There is still little international portfolio investment focus on Bulgaria apart from Brady bonds, which are generally traded in London. The domestic market is practically nil, and financial statistics show that net portfolio flows have been negative since 1998. Given such circumstances, it is all the more impressive that Bulgaria has been able to privatize its banks with strategic foreign capital.

There is still strict observance of confidentiality by the authorities. This undermines disclosure practices, and has kept the BNB credit registry modest in terms of information dissemination. Meanwhile, private rating agencies have played virtually no role apart from a few ratings, mainly on sovereign ratings and a few of the larger financial institutions.

1.7. Financial Media: Insufficient Basis for a Score

No particular effort was made to assess the financial media. However, there are several newspapers that report daily and weekly figures regarding monetary issues, trade volumes, exchange rates, etc. This is consistent with the improved legal environment for BNB and the commercial banks, and appears to reflect a commitment to increased public disclosure. The reporting appears to be professional, accurate and objective.

In addition, BNB, the banks, brokers, insurance companies, and other financial institutions have web sites that provide information on their status along with commentary. In general, information flows appear to have increased since end 1997. The recent EU report on Bulgaria's progress toward EU accession reported no problems with issues of information and media communications in Bulgaria, including (by extension) in the financial sector. While there are rumors, half-truths, and sometimes unsubstantiated reports, the financial media generally provide a useful amount of information to the public.

The Law on Banks does specify that the dissemination of false information that can undermine the reputation of a bank can lead to a fine of 50-200 million leva—up to nearly $100,000 at end 2000 exchange rates—for media concerns. Higher penalties can be assessed if criminal activity is proved.

1.8. Professional Associations: Score: 3- *(vs. 2+ in 1998)*

There are many business and professional associations focused on financial sector development. **The Association of Commercial Banks (ACB) is the main banking association,** coordinating with the banks on a number of regulatory issues and working with BNB, MoF and Parliament. ACB also coordinates with the International Banking Institute to provide training to bankers. However, the ACB has been criticized in some cases for not being open and transparent in terms of its efforts to lobby government on behalf of the sector, and for its own appointments and governance practices.

The Bulgarian International Business Association (BIBA) represents the foreign business community, and includes several large international financial services firms, including Allianz and AIG in insurance, 16 of the largest banks, four of the Big 5 accounting/management consulting firms, and other financial firms in leasing, fund management, and development banking. BIBA's recently formulated annual White Paper contained a substantial number of recommendations regarding financial services, taxation, privatization, manufacturing, and other areas of concern. The previous government demonstrated the seriousness with which it took such recommendations by responding point by point in a 52-page tabular response.

There is a 29-member **Association of Bulgarian Insurers** focused on professionalizing standards, ensuring competition and a conducive business environment in the insurance sector, and meeting EU requirements by harmonizing legislation and accounting with EU directives. The accounting profession is represented by the **Bulgarian Institute of Certified Public Accountants**. There is also a **Chamber of Auditors**. The securities profession has the **Association of Licensed Investment Intermediaries**, while private pension funds are represented by the **Bulgarian Association of Supplementary Pension Insurance Companies**.

1.9. Academic: Insufficient Basis For a Score

No systematic effort was made to determine numbers of courses, students, institutes, or other academic matters. Nor was there a systematic effort to speak with business/management school officials. There are several think tanks that make a significant contribution to banking sector reform and development, and general economic policy. There are reported to be about 65 management training institutes in Bulgaria. However, **management training in both financial services and the real sector represents a major need in Bulgaria**. For the banking sector, this is important directly for an adequate supply of professional staff, and indirectly to have greater confidence in the management skills and teams of companies seeking to borrow.

1.10. Miscellaneous: Score: 3 (same as in 1998, which is now considered too high in retrospect)

There has been some slow movement towards privatization of the fixed-line telecommunications market. BTC is the fixed-line monopoly, and it is now slated for privatization in 2003-04. **There are two companies operating in the mobile telephone market**, and a third GSM license is expected to be issued by 2002 before BTC's fixed-line monopoly comes to an end. **There has been some development of electronic commerce**, and Bulgaria will soon permit electronic signatures to be used as a stimulus for such transactions. **Safekeeping from a physical and logistical standpoint appears adequate**, and this will improve with movement towards RTGS. However, no systematic effort was made to review this. The postal system still provides payment services for communities that find it difficult to access retail banking services.

Section 2: Assessment of Economic and Structural Factors

***II. Economic Factors and Indicators: Score: 3** (vs. 3- in 1998)*

Overall macroeconomic performance in the late 1990s has shown significant improvement when compared with the volatility and downward trends of the mid-1990s. While overall output has not fully recovered from one year before the transition began, there have been noticeable and impressive accomplishments since the collapse in 1996. **Real GDP growth has been registered for three straight years**, with 2000 having been the best year since the transition began in the early 1990s. While the unemployment rate remains high, the general growth in the economy and recent introduction of measures to make hiring/firing more flexible should help bring down the official unemployment rate. **Pricing stability has been broadly restored** with the currency board arrangement (CBA), as shown in the relatively low inflation rates achieved since 1997-98. **This has been combined with impressive fiscal discipline**, as budgets have been kept largely in balance since 1998. Given the restrictiveness of the CBA, progress on the inflation front could have been undermined by fiscal laxity. This has not been the case.

In addition to relatively low inflation rates, **there has been an increase in broad money and deposit mobilization with the banks since end 1997**. While funds held with the banks are not as high as they were in earlier years, this is largely due to the high proportion of cash transactions that occur. This points to a weakness with regard to compliance with fiscal requirements. Nonetheless, **fiscal revenues are increasing, and the onerous tax burden associated with personnel benefits (e.g., social insurance) and personal income taxes is shifting to consumption-related taxes (e.g., VAT, excise).** Thus, while the informal sector still accounts for a large proportion of activity and tax evasion remains high, there are now signs that fundamentals are improving. The government is in the middle of a tax rate reduction program, and both revenues and expenditure are increasing without incurring deficits exceeding 1 percent of GDP. The new government is contemplating additional reforms that could accelerate some of the proposed changes (i.e., bringing the corporate tax rate to zero when profits are reinvested, raising the threshold for personal taxes). As the fiscal burden diminishes and banks provide more incentives for households and enterprises to place funds in their institutions, broad money is expected to increase. This will have a positive effect on intermediation trends in the coming years.

Meanwhile, **the balance of payments continues to show positive data and trends**. Current account deficits are still high, but the structure of the deficits point to ongoing retooling for export-oriented competitiveness, rather than wasteful consumption of luxury consumer goods. This is also reflected in growing levels of direct investment, some of which is derived from CEFTA and EU investors in greenfield operations. Bulgaria's international transactions have increased in volume, including its exports. This is projected to continue as its trade is increasingly integrated with EU markets, now at about half of total trade as compared with about one third in the mid-1990s. Debt management also continues to be adequately conducted, notwithstanding areas that could be improved with regard to exchange rate and maturity mismatches. Foreign exchange reserves provide Bulgaria with about six months of import cover, debt-to-GDP continues to decline, and the market shows no worries about Bulgaria's ability to meet its international obligations.

Apart from still high levels of tax evasion/aversion, **the main weaknesses in the economy appear to be structural, judicial, and related to the underdevelopment of the capital markets**. While the previous government made significant progress with bank privatization, its enterprise privatization program was less impressive. **The preponderance of management-employee buyouts (MEBOs) has done little to improve enterprise competitiveness, efficiency and governance**. Likewise, mass privatization has provided some compensation to voucher holders, but has done little to promote economic growth. Banks that still have these enterprises as clients are at risk because of their continued restructuring needs.

Meanwhile, **the capital markets have offered virtually no outlet for most enterprises because they are unable to achieve listing requirements. The markets themselves are non-transparent, and turnover and capitalization figures indicate that there is significant work to be done to activate the markets. This effort should focus on strengthening company performance, and not on easing listing requirements to sub-standard levels**. If the latter approach is pursued (allowing for reasonable differences between primary and parallel markets), the benefits of disciplined markets will not generate the kinds of liquidity needed for markets to operate efficiently in Bulgaria. Private pension funds, life insurance companies and major banks offer the long-term opportunity for institutional investors to help develop corporate bond and equity issues, as well as to serve as a source of demand for government securities once the CBA lapses and Bulgaria joins the EMU. However, this is a long way off. In the meantime, companies themselves will need to address a long list of governance, management and financing fundamentals to be attractive to investors on markets. Development of these markets and linkage with regional markets (e.g., Athens, Vienna) would be helpful for the development of securitized products (e.g., mortgage-backed securities, warehouse receipts, factoring), and for exit mechanisms to be in place for venture capital, turnaround companies, vulture funds, etc. As of now, Bulgaria has fared poorly in this area.

Having mentioned structural weaknesses, which include high levels of public sector employment, **there is still irreversible movement towards a private sector-oriented economy**. The general estimate of private sector GDP is about 70 percent. The state remains involved in only a few areas of the economy. Lending to the state sector has virtually disappeared. Thus, while structural weaknesses persist, there is confidence that new investment and increased exports will usher in a more competitive economy based on more sustainable prospects for growth. All of this is in stark contrast to conditions of collapse in late 1996/early 1997.

2.1. General: Score: 3 *(vs. 2+/3- in 1998)*

Macroeconomic data are broadly positive, and represent improvement from the mid-1990s. Real GDP growth has been steady since 1998, notwithstanding drought in 2000 and a general reconfiguration of the economy since then towards services. Inflation rates have come down to manageable levels from the hyperinflationary period of the mid-1990s. The fiscal accounts are generally in balance. Bulgaria is showing signs of increasing competitiveness, both in terms of labor productivity and in terms of export growth. The latter is impressive considering that its exchange rate is pegged 1:1 with the Euro, thereby providing no flexibility in creating a currency-related advantage to increase exports to its major trading partners. General financial indicators such as debt levels and foreign exchange reserves continue to improve. The latter is partly driven by Bulgaria's increasing ability to attract foreign direct investment, which approximated $1 billion in 2000 for the first time.

Weaknesses are generally at the structural level. Public sector employment remains high, while the unemployment rate also remains high. Informal sector activity continues in the 30-40 percent of GDP range, largely to avoid what are perceived to be onerous tax burdens. Methods of privatization are broadly criticized as having done little to improve competitiveness and efficiency in these companies. Corruption is still pervasive, and many critics believe that some of the larger companies that remain state-owned (e.g., BTC in telecommunications, Bulgartabac) could have been privatized earlier and generated significant proceeds.

2.2. Private Sector Development: Score: 3 *(vs. 2+ in 1998)*

Bulgaria is on an irreversible course of private sector growth, with particular strength in services and growing strength in the industrial sector. Virtually all sectors of the economy are now driven by private sector companies with the exception of the water, gas and electricity sector, telecommunications (where there is private competition from two GSM operators), and a handful of other companies that are either minor to the economy (e.g., mining) or to be privatized in the next few years (e.g., tobacco, tourism). **Since 1997, private sector output has increased from $6.1 billion (1997) to an estimated $9.1 billion (2000). This has been accompanied by increasing productivity, and more recently, a sizable increase in export volume**.

The structure of the economy has broadly shifted in the last four years. At end 1997, agriculture accounted for 27 percent of output, as compared with 15 percent in 2000. The shift in composition has generally been visible in services, which now accounts for 56 percent of GDP. Industrial share has settled at about 28 percent of GDP since 1997.

In terms of employment, the state remains a major employer, accounting for 47 percent of the total officially employed work force. While government employees and employees of state-owned enterprises are comparatively well paid, the statistics may be off. Private sector compensation is generally less than public sector employment, but it is commonly acknowledged that private sector rates are deflated by employers to avoid/reduce tax obligations. Some of the foregone tax payments from employers are paid in cash off the books to employees.

As for firms and firm size, Bulgaria had about 200,000 or so registered enterprises. It is uncertain how many are operating at commercially viable levels. While the total number of registered firms is about 210,000, another source reported only about 70,000 firms with more than five employees. **It is possible that nearly two thirds of registered firms are operating at sufficiently low levels of utilization to be considered non-viable.** In general, firms are small-scale in Bulgaria.

Government recognizes the need to improve the business environment, and has recently taken measures to make conditions more conducive to the private sector. A significant number of licensing and registration requirements have been streamlined. Direct tax rates on corporate profits, personal income, and personnel benefits (e.g., social insurance) are coming down in a bid to increase compliance. Recently introduced pension reform is meant to shift some of the burden away from employers to employees. Meanwhile, depreciation schedules are being revised to stimulate greater investment in high technology ventures and to stimulate increased re-tooling of manufacturing (including agro-processing). Faster VAT refunds are intended to serve as a catalyst for leasing and other activities that require major up-front investment. The new government appears committed to sustaining these reforms, and possibly adding/accelerating in the form of tax relief on securities transactions, interest income, and retained earnings.

There is still skepticism among many that government reforms and initiatives have not done enough to rein in corruption, to streamline the tax burden, and to move forward with greater transparency in privatization transactions and securities market development. Nonetheless, many of the fundamentals appear favorable, as shown in increasing levels of investment, productivity and export volume. Should real GDP continue to increase at 5-6 percent, as in 2000 and as forecasted, this should help in bringing down the official unemployment rate, making the fiscal base more viable, and increasing Bulgaria's prospects for competitiveness and sustainable growth.

2.3. Money, Savings and Credit: Score: 3+ *(same as in 1998)*

Conditions have broadly improved in terms of monetary policy and management in recent years. The CBA has induced financial discipline, which has translated into relatively stable inflation rates (despite a rise in 2000 due to dollar-denominated pricing of key import commodities, and a general depreciation of the Euro to the dollar) since 1997-98. This compares with the collapse of the Bulgarian economy in 1996-early 1997, during which bank deposits declined from $7.4 billion at the end of 1995 to $1.8 billion at the end of March 1997. While there are still some risks, mainly related to exchange rate and maturity mismatches that could have a marginally destabilizing effect on the economy (e.g., a sharp drop in the Euro would add stress to the debt profile and exacerbate the current account deficit), monetary management has been broadly viewed as stable and contributing to sustainable real growth.

While broad money levels are still below aggregates achieved in 1992-96, there has been an increase since 1997 of about $700 million, or about 20 percent in dollar terms. Deposits held with banks have likewise increased $415 million (net) since 1997. Under the current circumstances in which banks are paying negative real interest rates on deposits, it is actually a significant accomplishment that funds have been mobilized. In fact, the paucity of investment opportunities for banks has served as a disincentive to deposit mobilization efforts until recently, as their assets have been largely placed in low-risk, low-return investments. Banks' movement towards expanding retail/consumer banking operations in Bulgaria reflects a turning point from stabilization to growth. This is expected to alter deposit-related features and pricing as banks increasingly seek to build franchise value. Along with other developments (including tax rate reduction for businesses and households), it is expected that deposits with banks will increase, and that banks may increase rates paid on medium- and long-term instruments to provide greater stability to their funding bases.

In the banking sector, the CBA significantly curtails the abuse of refinancing and lender of last resort embedded in monetary policy and credit practices through the end of 1996. This has translated into low levels of lending, which currently stand at about 12-13 percent of GDP.

However, the last three-four years have had a cleansing effect on portfolios, and **most banks now generally have significant capacity to lend relative to capital levels**. This is particularly true of the Group I-III banks, which are the largest banks. Branches of foreign banks (Group V) likewise can access additional funding as needed. Thus, while there have been critics of the stabilizing developments of the last few years, banks now appear poised to increase their lending and risk assumption. Part of the reason is due to the stable monetary environment created by the CBA, which has also contributed to foreign investment into the banking sector.

2.4 Fiscal: Score: 3+ (vs. 2+/3- in 1998)

Fiscal developments have been broadly favorable since 1997. Policy has been consistently geared to reduced deficits. These were achieved as early as 1997, one year after the economic collapse. Since then, the average fiscal deficit has been less than 1 percent of GDP. Given fairly tight monetary conditions emanating from the currency board regime, this is an impressive accomplishment. As a sign of discipline, financing of the state enterprise sector has been reduced to virtually zero after major financing in the early/mid-1990s.

Meanwhile, the previous government made progress in a number of structural fiscal areas. **Revenues and expenditure have both increased since 1997**, with the fiscal accounts benefiting from a shift away from direct to indirect and consumption-oriented taxation. Rates continue to decline while collections continue to increase. The shift to increasing reliance on VAT and excise, 32 percent of fiscal revenue in 2000, has made it possible for rates to come down on corporate profit tax rates, personal income tax rates, and mandatory employer social security contributions. The new government has expressed an interest in accelerating reforms in these areas.

Meanwhile, all of this has been accomplished despite dubious competitiveness resulting from privatization transactions, high levels of tax avoidance, and continued high stocks of external debt that are regularly serviced through the budget in six month intervals. **Continued growth in real GDP and international transactions, recent improvements in VAT refund provisions, and continued reductions in personal/corporate tax rates should continue to increase the fiscal base and revenues**.

2.5. Exchange Rates: Score: 3+ (vs. 3 in 1998)

Bulgaria's exchange rate policy has been fixed to the DM and then Euro since introduction of the CBA. This followed a period in which the earlier Bulgaria lev had depreciated rapidly from 1995 to 1996, reflecting the earlier policies that relied heavily on borrowing and refinancing to prop up inefficient state industries and government operations.

The two basic weaknesses Bulgaria faces with the CBA are the inability to permit the currency to depreciate as a catalyst for increased investment and exports, and the current deterioration of exchange rates in relation to the US dollar. The latter is important due to the structure of Bulgaria's debt (which is about 65 percent dollar-denominated), and the international pricing of imported energy and other commodities in dollars. Meanwhile, as long as the Euro remains weak against the dollar, this will make debt service and the import bill more costly. Bulgaria also cannot pursue a currency devaluation policy to stimulate exports to its major trading partners in the EU. On the other hand, the CBA has benefited Bulgaria's economy with strict and predictable discipline that has squeezed out virtually all of the earlier leakage that brought Bulgaria to economic collapse in 1996. **The recent increase in FDI and export volume, combined with broadly favorable macroeconomic indicators suggests the benefits of the CBA have**

outweighed the costs during the last four years of stabilization. Moreover, public opinion polls continue to show that the public firmly backs the CBA as a source of pricing and exchange rate stability.

2.6. Balance of Payments: Score: 2+/3-(vs. 2- in 1998)

Bulgaria's balance of payments has shown generally positive results in recent years. **While there has been an increase in the current account deficit, this is partly due to the increasing importation of goods being used to make manufacturing and services more competitive**. The results have already been manifested in increasing exports, primarily in petroleum products and footwear and leather goods. Meanwhile, interest service figures are higher due to dollar-denomination of the balance of payments. While this reflects the composition of debt and exchange rate movements, there has been no market concern about Bulgaria's ability to service or repay debt in a timely manner.

Since April 1997, Bulgaria's economy has remonetized, and this is showing up in improved capital account figures. There has been a significant increase in gross foreign exchange reserves. As of end 2000, these stood at $3.5 billion, or equivalent to about six months of import cover. By contrast, gross foreign exchange reserves were only $0.8 billion-equivalent at end 1996, roughly one month of import cover. This is all the more impressive as imports have grown steadily in recent years.

One of the major reasons for Bulgaria's stronger balance of payments position is the increase in foreign direct investment, even though portfolio outflows have been negative since 1998. In 2000, this amounted to $1 billion, or 8 percent of GDP, as compared with a mere $138 million in 1996, or 1.4 percent of GDP. While much of the FDI was previously put into the manufacturing sector, most of it related to the two major bank privatizations (UBB and Bulbank) in 2000. This will serve as a stimulus for domestic spending on MIS/IT and personnel, and have the larger effect of intensifying competition in the banking sector. Meanwhile, **the debt profile continues to improve**, with external debt declining from nearly 97 percent of GDP in 1996 to 86 percent at end 2000.

Overall, Bulgaria's balance of payments are showing improvement. The results achieved in the last few years stand in stark contrast to the balance of payments crisis through the current account in 1993, and finally the capital account via declines in reserves in 1996. However, as before, **Bulgaria runs the risk of slowing progress due to incomplete reforms at the structural level**. While the previous government was effective at curtailing financing of inefficient state enterprises, the new government will need to complete the reform effort in the enterprise sector (accompanied by major judicial reform for better private sector incentives) to sustain progress towards competitiveness. Short of that, **Bulgaria will be vulnerable to a slowdown in the Euro-zone economies**, particularly as its own domestic economy with 8.2 million people is still relatively small and limited in terms of aggregate long-term purchasing power. **Meanwhile, any export slowdown with its EU trading partners cannot be easily offset through trade, as nearly 25 percent of imports are energy products from Russia**.

Section 3: Assessment of Banking Structure and System Profile

III. Banking Structure and System Profile: Score: 3-/3 *(vs. 2+ in 1998)*

Bulgaria was at the beginning of the adjustment process in the banking sector in 1997. Major legal and regulatory reforms were introduced in 1997-98. Technical assistance was on the ground to shore up institutional capacity in banking supervision, and to help establish a plan and implement bank privatization. At the time, it was hard to even get a sense of basic asset values, given hyperinflation, the lack of active and transparent markets for fixed assets, and the deep problems of the loan portfolio. There was virtually no concept of risk management in place (apart from a few of the major foreign banks that had established small banks or branches), and the incentive structure was geared to political patronage and forbearance rather than commercial viability and cash flow.

Since then, conditions have vastly improved. Five of the six major banks slated for privatization have been privatized, and the last remaining bank is not a major bank. **While four other banks remain state-owned and should be privatized, 80 percent of the banking system is now privatized and largely foreign-owned. Banks have high capital adequacy ratios, and asset quality is better than a few years ago.**

Recent foreign investment is serving as a catalyst for increasing competition in the small corporate market, and for new investment in retail expansion that is expected to significantly increase the penetration rate of banks in the enterprise and household sectors. New systems are being put in place to manage associated risks. These investments and systems are expected to add to product offerings, with the anticipated effect of growing bank balance sheets and increasing intermediation levels. All of this should spur on continued economic growth.

While growth and intensified competitiveness are projected, consolidation is also projected. With 35 banks, Bulgaria is likely to see this number decline in the coming years. There is nothing wrong with this development. In fact, this should help, as many of the banks have low levels of aggregate capital, and little to offer the marketplace in terms of loan size or non-credit services apart from rudimentary safekeeping.

In anticipation of these developments, **one of Bulgaria's most critical needs is to devise a strategy for bank resolution**. This can be done in a number of ways. One approach is to create incentives to consolidation prior to the risk of deteriorating bank-specific financial conditions. Raising levels of minimum capital is one technique. Regulatory inducements are another. Short of that, BNB and the government will need to think through the potential economic cost of having a large number of small banks that could potentially engage in practices that could harm system stability overall. Nonetheless, for the time being, this does not appear to be a major risk. Overall, the banking sector is now financially stable and poised for growth.

By contrast, in the non-bank sector, little has occurred. The securities markets are weak and characterized by low turnover and market capitalization. The insurance sector is underdeveloped and in need of a strategic framework to ensure that companies are financially sound, committed to observing standards of consumer protection, and able to properly monitor the risks associated with their underwriting practices. **Recent pension reform bodes well for private savings, although there are doubts about the size of voluntary contributions to be made in the coming years as long as purchasing power remains relatively low**. Meanwhile, mandatory contributions will also be sub-optimal until tax avoidance/evasion declines to more modest levels. If contributions do not reach targeted levels, **the authorities will need to also have a contingency plan in place in the event that one or more private pension funds come under financial stress. This is also the case in the insurance sector** if a firm is financially troubled and unable to honor claims. Beyond that, there are opportunities to develop leasing, factoring, commercial finance, mortgage lending and other financial services. However, these markets remain largely underdeveloped.

The quality of management and governance varies, although standards are largely improving with modernization and competition. While the foreign-owned banks and many of the more competitive domestic banks are considered sound in terms of board composition, management capacity, internal controls, and systems, there are other banks that are not considered as strong. Without regulatory controls, some of these banks would otherwise pose a potential threat to systemic stability. In the meantime, many of the older banks that have not attracted new capital and shareholders are reported to require improvements in board composition, management capacity, organizational structure, and quality of information. Some of these problems can be remedied by introducing independent and outside board members (particularly for Audit Committee participation), increasing checks and balances in management roles and responsibilities, reconfiguring existing top-down structures to be more horizontal in their functions, establishing better channels of internal communication, and maintaining closer and more regular links with external auditors.

The new government will need to address the "strategic framework" issues in a more organized fashion now that they have embarked on accession negotiations with the European Union. Several market players and others have commented that legal and regulatory changes are haphazard and frequent, and that this undermines confidence and planning for the future. Specific examples of policies that work at cross-purposes, or problems associated with the need for better harmonization across financial products and services are commonly noted. Now that the system has stabilized and the financial sector is poised for growth, it may be in the interest of government policy makers, various financial regulators, and market players across the financial services industry to participate in a comprehensive strategic framework exercise to smooth out these inconsistencies. While broad in scope, this would likely provide the needed clarity of freedom and maneuverability for financial institutions at a time when they are planning for growth and expansion.

3.1. Overview: Score: 3- *(vs. 2 in 1998)*

Bulgaria has made impressive progress since 1997 in stabilizing the banking system, and putting it in a position for growth and diversification. The system is now dominated by strong regional banks (from Italy, Greece and Austria), supplemented by prime-rated global banks (from the Netherlands, France, Germany and the U.S.). While the system is still small, at less than $5 billion in total assets, it is poised for growth due to high capital and liquidity ratios, and relatively clean loan portfolios.

There are clear indications that bankers have confidence in Bulgaria's future prospects. As an example, many of the global players are currently investing in retail networks, rather than keeping their operations focused on low levels of risk and off-balance sheet activities. While banks have been criticized in recent years for not lending, they are now tooling up to do more than lend. Their current agenda is to provide a wide variety of products and services to enterprises and households, with the intention of diversifying their earnings stream and moving away from passive, low-return investments in low-risk securities and paper (mainly abroad).

Increasing competitiveness is likely to improve overall offerings and service levels. Nonetheless, it will also put pressure on the weaker banks. **With 35 banks in Bulgaria, about half of which are either small and/or weak, it is expected that many of these will disappear in the coming years**. There is a risk that such pressure could lead to political patronage, selective forbearance, and other practices inconsistent with market-based rules of engagement. There are several other risks that could materialize as a result of such pressure, including losses resulting from adverse selection, aggressive pricing on deposits to increase funding unavailable in the inter-bank market, and imprudent use of lender of last resort provisions. **A clear, consistent and sound framework for bank consolidation and resolution needs to be developed in anticipation of such possible developments**.

Donors also present a risk, as subsidized loans can lead to market distortions and support for institutions that otherwise would not survive. Extraneous investments for portfolio purposes can also encroach on market development. Thus, **given that the market is now poised for real growth, donors' involvement should be less on direct financing of projects through institutions (or on equity investments in the already over-capitalized banking sector), and more on building the needed infrastructure (e.g., laws, regulations, institutional capacity) for market development to proceed under stable conditions**.

3.2. Ownership: Score: 3+ *(vs. 2 in 1998)*

The banking system has gone through a major reconfiguration of ownership since 1997. As of end 1997/early 1998, the banking system was heavily weighted towards state banks. Since then, most of the major banks have been privatized, primarily by attracting strategic investment from abroad. This transformation includes the sale of nearly 100 percent stakes in Bulgaria's two largest commercial banks in 2000 to Italian and Greek banks. At least another 20 banks are at least partly foreign-owned, accounting for a total of about 70-75 percent of banking system assets.

At the end of 2000, only about 20 percent of assets remained in state-owned banks. This is in stark contrast to the 82 percent share at end 1996 and 66 percent share at end 1997 (due to the closure of smaller insolvent banks). Of the remaining state-owned banks, two (Biochim and Central Cooperative) have already begun initial privatization discussions. A third, DSK, is the former state savings bank that operates under a fairly narrow set of restrictions with regard to lending. A fourth, Promotional Bank, was established to encourage lending to SMEs. **It would behoove the new government to move forward as rapidly as possible with privatization of these state banks to avoid the risk that they could be used in the future to revive earlier practices of connected lending.**

3.3. Governance and Management: Score: 3- (vs. 2+ in 1998)

Governance and management have improved in most banks since 1997, although there are still reported to be many weaknesses at the smaller banks. Positive developments include the risk management expertise that has been a part of foreign bank privatization, improved MIS, investment in IT, development of the internal audit function, increasing use of international standards of accounting and audit, and stricter qualifications required of board members. Much of this derives from improvements and changes that were introduced through laws and regulations adopted in 1997-98.

In terms of governance, there is a commitment to holding boards responsible for the business plans of their banks, satisfactory internal controls and reporting, and compliance with laws and regulations. Management is expected to implement these plans accordingly. **The larger task now is how banks will manage risks as conditions become more competitive**. This transcends fundamental credit risk, and is likely to take on a more consolidated profile over time as banks eventually enter insurance markets, increase their roles as investment intermediaries for private pension funds, and expand their activities in the capital markets (via brokerages as well as potentially as institutional investors). For smaller banks where management capacity may not be as deep, this challenge is likely to create additional operational and informational problems that will need to be tackled to ensure risks are under control.

These will also be critical challenges to BSD at BNB, both for off-site surveillance and the workings of the early warning system, and the on-site department to follow up on a timely basis with targeted examinations. As banks diversify, this will also require sound and timely coordination among the various financial services regulators. The hiring of BNB personnel by some banks may help with regulatory and systems compliance, and the internal audit function. If so, this represents a contribution to corporate governance and management capacity in the banking sector. This will likely be tested in the coming years.

3.4. Non-Bank Competition: Score: 2 (same as in 1998)

There is still limited competition for and complementarity to banks in the marketplace, which has also perpetuated the notion that banks should provide the vast majority of funding for enterprises. It is not uncommon to look to banks to play this role, particularly as traditional universal banks in continental Europe tend to play a more concentrated role in the financing of enterprises than in other markets. Nonetheless, with the introduction of modern prudential norms, banks are simply unable to provide the amounts of financing demanded, even if the banks would like to. This is due to basic restrictions on large loans, concentrations of exposure, etc.

Among other financial services, **the capital markets are weak in Bulgaria**. They are characterized by low turnover, which is all the weaker on average due to the disproportionate role of block trades on an otherwise illiquid market. Market capitalization for the entire Bulgarian Stock Exchange was less than $500 million at end 2000. Future moves to increase regional links, enhance OTC opportunities, and make trading more transparent would all help with securities market development.

Contractual savings instruments are beginning to appear, particularly with recent pension reform. Bulgaria introduced reforms in 2000 to move to a sustainable three-pillar scheme. Since then, nine active pension funds have attracted more than 400,000 insured and \$35-\$50 million to their voluntary funds in the first year or so of operation. While this signifies progress, it is unclear the degree to which people born after 1959 will continue to make contributions for future retirement benefits should their purchasing power remain relatively low. Meanwhile, insurance activity is beginning to increase, including in the life insurance sector. Life insurance was about one third of total premium revenues in 1999, or about \$100 million-equivalent. It will take time for contractual savings instruments to capture sizable market share, and for these funds and companies to be in a position to play a major role as institutional investors.

There is limited development of factoring, commercial finance, leasing or other types of financing that could serve as either competitors to or partners of banks. Some bank financing of leasing activities occurs, and some of the banks' lending to companies is comparable to commercial finance in more developed markets. There has been some initial mortgage lending, although this has not become a major activity yet for banks or non-banks.

Section 4: Assessment of Banking Sector Development Based on Prudential Norms

IV. Banking Sector Development Based on Prudential Norms: Score: 3 *(vs. 2+ in 1998)*	**Bulgaria has accomplished a great deal since 1997, not the least of which is stabilization of the banking sector, implementation of an improved prudential regulatory framework with which the banks are able to comply, and a general framework for sustainable growth and development of intermediation capacity that is prudently managed relative to risk assumed**. Capital adequacy is high, which reflects substantial extra capacity. Asset quality has improved significantly, with standard loans now 92 percent and loss loans less than 4 percent. Liquidity ratios are high, partly a reflection of banks' limited alternative investment opportunities. Thus, CAL measures are generally strong, notwithstanding adjustments that may occur between preliminary figures issued by BNB and externally audited statements. **However, banks' earnings are not particularly strong, partly because their approaches have been conservative**. Even when companies are known to be credit worthy, their inability or unwillingness to comply with underwriting standards has translated into investments in low-return paper and securities, usually in offshore banks, rather than lending to Bulgarian enterprises. This is beginning to change now that competition is heating up. Moreover, banks' 20 percent return on average capital and 3 percent returns on average assets are not bad for a low risk environment. However, given the small base of activity, overall earnings are limited, particularly for many of the smaller banks. Thus, moving forward, banks can be expected to take on more risk in pursuit of higher earnings. **The trend towards greater risk assumption will require adequate risk management systems to be in place**. The investment-grade international and regional banks have this capacity. It remains to be seen how much risk other banks will take in the Bulgarian marketplace, and how well they will manage these risks. This will need to be monitored carefully by BSD, as well as by the banks in assessing their exposure to the inter-bank market. This will primarily focus on fundamental credit risks, but also on underlying mismatches or gaps regarding interest rate features, exchange rates, and maturities. This will call into question not only the management capacity of individual banks, but also the efficiency and timeliness of MIS and the ability of individual banks to identify and contain risks early on to prevent adverse effects on portfolio quality and earnings.

4.1. Capital Adequacy: Score: 3 *(same as in 1998, although this is now viewed as high in retrospect)*

Bulgaria's banks are currently "overcapitalized" in terms of CARs, while being relatively small on average in terms of actual capital. CARs at end 2000 were about 36 percent. Even with some adjustments after audited statements, this suggests that banks have excess capital relative to risk-weighted assets. **Now that banks are poised for growth and seeking higher earnings, it is assumed that they will more actively deploy their capital**.

In terms of aggregate capital, **the Bulgarian banking system had about 1.4 billion leva at end 2000, or about $656 million. This averages about $24 million per bank net of foreign bank**

branches. Thus, the average bank cannot generally make loans in excess of $2.4 million, which is very small by international standards.

4.2. Asset Quality: Score: 3 (same as in 1998, although this is now viewed as high in retrospect)

Based on preliminary year end BNB figures, **the banks' loan portfolios remain satisfactorily provisioned, with most loans standard (92 percent) and loss loans under control (3.4 percent). This represents a major improvement from only 79 percent standard loans at end 1997, of which a substantial portion of the balance were loss loans**. Since then, banks have been very conservative in terms of their lending policies. Loans have been more than fully secured (at least in terms of paper value), and a majority of earning assets have been placed in primarily investment-grade paper in offshore banks. The positive side of this approach has been risk containment. The negative side has been relatively unimpressive earnings, passive approaches to asset management, and foregone opportunities for economic development.

4.3. Management: Score: 3 (vs. 2+ in 1998)

There have been improvements in management due to the strengthened incentive structure introduced into the banking system in 1997-98. However, because banks have still not moved forward aggressively in assuming more risk, **it is too early to evaluate how adequate systems are, and how much better prepared management teams are to identify and contain problems when they emerge**. It is expected that the major foreign banks will be able to handle these problems based on their experience from abroad. However, there are questions about the ability of Group IV banks in particular to manage these risks.

Beyond that, there are also fundamental organizational issues related to efficiency and the management of cost structures. In general, banks have high costs, and their net earnings are largely based on low rates of interest paid on deposits. Market competition will test these banks' capacity to adapt to more active management of risks and costs.

4.4. Earnings: Score: 3- (vs. 2 in 1998)

Banks have shown positive earnings since 1997, although in 1997, this was due to translation adjustments. **Since 1998, earnings have been relatively meager due to low levels of risk assumption on the asset side. Margins have been made less on cost effectiveness or new efficiencies, and more on the basis of negative real rates paid on deposits**. Banks have generally not yet built up a diversified stream of non-interest earnings, although Bulbank appears to still generate reasonable returns on trade-related services. Apart from this, the earnings stream has been adequate—ROE and ROA were 20 percent and 3 percent, respectively, in 2000—but the mass of earning assets is not yet large enough for total income to be of any particular significance. **For 2000, average net earnings per bank were less than $4 million. Even if fully retained, this is not enough for the kinds of investments and systems needed for modern banking**.

4.5. Liquidity: Score: 3 (same as in 1998)

Bank liquidity ratios are high, partly reflecting regulatory requirements and partly reflecting risk aversion on the part of the banks. This is apparent in the pattern of asset management since reserve requirements were reduced from 11 percent to 8 percent. In most markets where intermediation rates are low, banks would have used the differential for lending to generate higher earnings. However, banks generally placed most of these funds in the same low-risk offshore bank paper that had been the destination of most of its other earning assets. Banks have followed this approach for several reasons, all of which are prudent. First, loans need to be more than fully collateralized, otherwise banks need to provision against the unsecured portion or the loan as a whole. Second, there is clear risk associated with lending in Bulgaria. Third, it is administratively cheaper for banks to simply place funds in offshore bank paper, rather than undertaking the hard work involved in underwriting credit risk. Fourth, offshore bank paper is readily marketable. Finally, it is easier for banks to comply with regulatory requirements. Thus, banks have been prudent to maintain high liquidity ratios.

The downside to all of this has been the relatively low returns banks have earned as a result of these approaches. Now that margins have begun to shrink in the corporate lending market, and because there is little government securities market from which to generate safe returns, many banks are now looking to take on more risk. This should bring liquidity ratios down, yet lead to higher earnings. Given the low aggregate earnings of the system in 2000, these kinds of developments are inevitable in developing a modern banking system. However, **banks and regulators will need to continue to monitor fundamental interest rate, exchange rate, pricing and maturity gaps to ensure that individual banks do not push the limits and endanger their ability to honor deposit withdrawals, guarantees, and other transaction requirements**. For the foreseeable future, this is not expected to be a problem. It is also expected that movement to RTGS will help banks with their liquidity management practices.

4.6. Operating Environment: Score: 3 (vs. 3- in 1998)

The operating and regulatory environment has improved in Bulgaria since 1997. **Laws and regulations largely conform to Basle and EU standards, and banking supervision has asserted itself with general enforcement of its mandate**.

Accounting standards are evolving increasingly towards IAS. External auditors have been used not only for annual audits, but also to point out improvements needed at banks with regard to MIS, IT, internal audit, and other building blocks of a modern banking system.

Deposit insurance is now in place, and an active fund supported by mandatory bank contributions has been established with borrowing authority to provide reasonable coverage. While insufficiently capitalized to date, this has to do with the relatively recent introduction of the deposit insurance fund. Two banks have been closed and deposit payouts orchestrated within 45 days. There was no public panic, suggesting that households and enterprises with deposits feel relatively confident their deposits are safe.

The government curtailed bank refinancing with the CBA, and **the lender of last resort function is limited to secured lines for liquidity support to viable banks that have run into short-term liquidity problems**. There has been no reported use of this function since the CBA was introduced in mid-1997.

Concentration has diminished as the market has opened up to competition. Bulbank and DSK retain strong positions in traditional activities. However, balance sheet indicators show a reduced level of concentration. Meanwhile, Bulbank has been privatized, and DSK has been required to operate under restricted lending conditions. Meanwhile, DSK also had its state guarantee on deposits removed as a condition of its ongoing right to operate.

4.7. Transparency and Disclosure: Score: 3 (vs. 3- in 1998)

The banking laws introduced in 1997 reflected a commitment to greater transparency and disclosure in the marketplace. Nonetheless, practices had not yet been reformed. By contrast, **there is a great deal more transparency and disclosure as of early 2001**. BNB and most banks have active web sites. New accounting standards, more open financial media, and a general opening of the market have helped to increase information flows.

Notwithstanding progress, pockets of weakness continue to exist. The BNB credit registry does not provide public information on borrowers, nor are there publicly disclosed ratings of banks apart from the rare ratings established by international rating agencies. The sluggish development of the capital markets has also undermined the push for greater transparency and market activity.

4.8. Sensitivity to Market Risks: Score: 3 (vs. 2+/3- in 1998)

Conditions have stabilized in Bulgaria since 1997, as demonstrated by improved portfolio quality, system earnings, nearly complete bank privatization, improved standards of governance and management, better control over mismatches, and Bulgaria's resilience in the face of economic, financial and political crises that have impacted various regional and neighboring markets. **This is a major accomplishment, considering that the country's economy was in a state of collapse at the end of 1996-early 1997**.

Moving forward, it can be expected that **the Bulgarian banking market will encounter greater volatility as a result of increased competition**. This will result in increased earnings and lending, diversification of products and services, introduction of more complex services that generate fees and commissions, and consolidation from 35 banks to a smaller number. Along the way, there are likely to be periodic losses or portfolio erosion that can spread to other banks and the system at large. This may be through the inter-bank market, as a result of certain alliances across financial services, or simply due to reputation and the concern the public may have on fundamentals such as deposit safety.

Most of the risks banks face in the next few years will be basic to banking—credit, interest rate, exchange rate, pricing, maturity. Banks will need to ensure they have adequate systems for credit risk evaluation and continuous loan monitoring. Being aware of who has controlling interests in borrowing companies will be essential in preventing serious losses from occurring. Strengthening the enforcement of creditors' rights through the court system will be needed. Likewise, when a bank fails, a more developed resolution framework will need to be in place for orderly liquidation. However, Bulgaria is not currently burdened with high levels of risky derivatives trading, excess guarantees, or over-exposed trade financing arrangements. Likewise, while banks are beginning to move into non-bank activities like insurance and private pension funds, these are generally being pursued as enhancements to their operations without putting fundamental balance sheet items at risk.

ANNEX 1: A DESCRIPTION OF THE USAID BANK RATING SYSTEM

Ratings Summary for USAID					
Topics/Categories and Description of Coverage	**Description of Ratings**				
	1 = DISMAL	**2 =RUDIMENTARY**	**3 =ADEQUATE**	**4 =SOLID**	**5 =OUTSTANDING**
General Description of Ratings: • Financial infrastructure • Economic factors and indicators • Banking sector structure and profile • CAMELOTS indicators	Monopolistic; state-owned banks dominate; no public confidence; lack of intermediation and widespread directed lending; lack of banking legal and regulatory structure; nascent regulatory institutions; widespread corruption	Little competition; weak household deposit growth; limited intermediation; diminishing directed lending; poor legal and regulatory structure and implementation	Growing competition; private banks dominate; steady household deposit growth; growing intermediation; adequate legal and regulatory structure, but inconsistent implementation; regulatory institutions are sustainable	Healthy competition; expanding intermediation to all enterprise sectors and households; growing lists of products/services offered; good legal and regulatory structure, and consistent implementation; credible regulatory institutions	Competitive globally; thriving financial intermediation; full range of products/services offered; diversified and sustainable earnings; strong legal and regulatory structure

I. FINANCIAL INFRASTRUCTURE					
Topics/Categories and Description of Coverage	**1 = DISMAL**	**2 =RUDIMENTARY**	**3 =ADEQUATE**	**4 =SOLID**	**5 =OUTSTANDING**
1.1. Policy/System	Wholly unsupportive of stable, safe and sound banking	Generally unsupportive of stable, safe and sound banking; significant improvements needed	Partly supportive of stable, safe and sound banking, but improvements needed	Supportive of stable, safe and sound banking	Wholly supportive of stable, safe and sound banking
1.2 Legal	Wholly unsupportive of stable, safe and sound banking and meaningful levels of risk-taking	Generally unsupportive of stable, safe and sound banking; virtually no meaningful levels of risk-taking	Fairly supportive of stable, safe and sound banking, but implementation deters meaningful levels of risk-taking	Supportive of stable, safe and sound banking and meaningful levels of risk-taking	Wholly supportive of stable, safe and sound banking and meaningful levels of risk-taking
1.3 Regulatory and Supervision	Wholly inadequate for prudently managed and supervised banking	Inadequate regulatory framework for prudently managed and supervised banking; significant strengthening needed	Adequate regulatory framework for prudently managed and supervised banking, but strengthening needed	Solid regulatory framework for prudently managed and supervised banking	Outstanding regulatory framework for prudently managed and supervised banking
1.4 Payments System	Wholly inadequate and undermines integrity of banking system	Inadequate and inefficient systems weaken limited efforts to build up integrity of banking system	Adequate but less than efficient systems support increasing integrity of banking system	Solid systems reinforce integrity of banking system	World class systems reinforce integrity of banking system
1.5 Accounting	Wholly inadequate framework for banking	Unacceptable framework for banking; significant improvement needed	Acceptable framework for banking, but sophistication needed	Satisfactory framework for banking	Outstanding framework for banking
1.6 Rating Agencies and Systems	Wholly unsupportive of banking sector development	Generally unsupportive of banking sector development	Marginally supportive of banking sector development	Supportive of banking sector development	Wholly supportive of banking sector development

1.7 Financial Media	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth; professionalization and code of ethics needed	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1.8 Professional Associations	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1.9 Academic	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1.10 Miscellaneous	Wholly inadequate and undermines integrity of banking system	Generally unsupportive of banking system; significant improvement needed	Only partly supportive of banking system, but improving	Supportive and reinforces integrity of banking system	Wholly supportive and reinforces integrity of banking system

II. ECONOMIC FACTORS/INDICATORS					
Topics/Categories and Description of Coverage	**1 = DISMAL**	**2 =RUDIMENTARY**	**3 =ADEQUATE**	**4 =SOLID**	**5 =OUTSTANDING**
2.1 General	Dismal macroeconomic fundamentals undermine banking sector development	Inadequate macroeconomic fundamentals deter risk-taking by banks	Adequate macroeconomic fundamentals assist with banking sector stability	Solid macroeconomic fundamentals provide banking opportunities	Outstanding macroeconomic fundamentals reinforce and enhance banking sector
2.2 Private Sector Development	Poor levels of private sector development in formal economy undermine banking development	Growing but inadequate levels of private sector development for sustainable, meaningful growth undercut banking sector development	Adequate private sector development supported by favorable trends, but improvements needed	Strong economy based on competitive private sector	World class, state-of-the-art economy predicated on innovative, resourceful private sector
2.3 Money, Savings and Credit	Dismal monetary fundamentals wholly undermine banking sector development	Weak monetary fundamentals deter banking sector development	Adequate monetary fundamentals boost confidence, but improvement needed	Solid monetary fundamentals contribute to strong banking system	Solid monetary fundamentals, shaped by world-renowned risk management practices, contribute to global standards of banking system competitiveness
2.4 Fiscal	Dismal fiscal fundamentals wholly undermine banking sector development	Weak fiscal fundamentals deter banking sector development	Adequate fiscal fundamentals boost confidence, but improvement needed	Solid fiscal fundamentals contribute to strong banking system	Solid fiscal fundamentals contribute to stability in support of banking system competitiveness
2.5 Exchange Rates	Dismal exchange rate fundamentals wholly undermine banking sector development	Weak exchange rate fundamentals deter banking sector development	Adequate exchange rate fundamentals boost confidence, but improvement needed	Solid exchange rate fundamentals contribute to strong banking system	Solid and stable exchange rate fundamentals, shaped by world-renowned risk management practices, contribute to global standards of banking system competitiveness
2.6 Balance of Payments	Dismal balance of payments position reflects competitive weaknesses of economy	Poor balance of payments position reflects competitive weaknesses of economy	Adequate balance of payments position reflects growing competitiveness of economy despite weaknesses	Reasonably strong balance of payments position reflects competitive strengths of economy	Enviably strong balance of payments position reflects competitive strengths of economy

III. BANKING STRUCTURE AND SYSTEM PROFILE					
Topics/Categories and Description of Coverage	**1 = DISMAL**	**2 =RUDIMENTARY**	**3 =ADEQUATE**	**4 =SOLID**	**5 =OUTSTANDING**
3.1 Overview	Wholly uncompetitive banking system	Poor reputation re competitiveness in the banking system	Adequate reputation for competitiveness in banking, but strengthening is needed	Solid reputation for competitiveness in banking	World class status re competitiveness in banking
3.2 Ownership	Monopolist, protectionist banking system resistant to foreign competition and change	Traditionally closed banking system only beginning to open up to foreign competition and change	Adequate levels of competitiveness and performance due to recent trend towards private ownership and management	Reasonably open and generally privately owned and managed banking system respected for competitive position	Open, privately owned and managed banking system globally respected for competitive prowess
3.3 Governance and Management	Dismal governance and management undermine banking and economic development	Weak governance and management undermine banking development despite recent but very marginal improvements	Adequate governance and management for banking, but improvements needed to achieve global competitiveness in banking	Strong governance and management sustain competitiveness in banking	World class governance and management reinforce and sustain competitiveness in banking
3.4 Non-Bank Competition	No serious competition from non-banks further undermines the need for financial discipline	Very limited competition from non-banks provide little pressure on banks to exercise financial discipline	Adequate levels of competition from non-banks, but lack of market breadth and depth limit impact on competitiveness and financial discipline of banks	Satisfactory levels of competition from non-banks enhance competitiveness and financial discipline of banks	Significant competition from non-banks further strengthens levels of competitiveness and financial discipline of banks

IV. BANKING SECTOR DEVELOPMENT BASED ON PRUDENTIAL NORMS					
Topics/Categories and Description of Coverage	**1 = DISMAL**	**2 =RUDIMENTARY**	**3 =ADEQUATE**	**4 =SOLID**	**5 =OUTSTANDING**
4.1 Capital Adequacy	Wholly inadequate capital	Inadequate capital	Adequate capital	Reasonably strong capital	Enviably strong capital
4.2 Asset Quality	Dismal asset quality	Poor asset quality	Adequate asset quality, although significant room for improvement	Reasonably strong asset quality	Enviably strong asset quality
4.3 Management	Wholesale disregard for fundamentals of risk management	General lack of awareness of risk management fundamentals	Fairly weak but improving reputation based on emerging risk management capacity in a market showing increasing levels of competition	Reasonably strong reputation based on satisfactory risk management capacity in a fairly competitive market	Enviably strong reputation based on world class risk management capacity in fiercely competitive market
4.4 Earnings	Sustained losses that have decapitalized the banks by IAS	Weak or unstable earnings	Adequate earnings, but room for added stability and diversification	Reasonably strong and diversified earnings	Enviably strong and diversified earnings
4.5 Liquidity	Severe liquidity problems	Liquidity problems	Adequate liquidity position, but room for strengthening	Reasonably strong liquidity position on an ongoing basis	Enviably strong liquidity position on an ongoing basis
4.6 Operating and Regulatory Environment	Dismal operating and regulatory environment	Poor operating and regulatory environment	Adequate and improving operating and regulatory environment	Reasonably strong operating and regulatory environment	Enviably strong operating and regulatory environment
4.7 Transparency and Disclosure	Dismal standards for transparency and disclosure	Weak standards for transparency and disclosure	Adequate standards for transparency and disclosure	Reasonably strong standards for transparency and disclosure	World class standards for transparency and disclosure
4.8 Sensitivity to Market Risk	Dismal reputation for sensitivity to market risk under market conditions	Poor reputation for sensitivity to market risk under market conditions	Adequate and improving reputation to manage sensitivity to market risk as market conditions increasingly prevail	Strong reputation to manage sensitivity to market risk under market conditions	World class reputation to manage sensitivity to market risk and continuously prosper under market conditions

ANNEX 2: A DETAILED ASSESSMENT OF THE BULGARIAN BANKING SECTOR

I. FINANCIAL SECTOR INFRASTRUCTURE

Bulgaria has made progress in advancing its financial sector infrastructure since 1997, and the invitation to join formal negotiations for accession to the European Union should keep the reform effort on track. However, much progress has gotten bogged down in the difficulties of implementation.

General policy has been supportive of a market-based system since after the collapse of 1996. This has been evidenced by the willingness of the authorities to permit strategic foreign investors to obtain a collective majority stake in the banking system. By contrast, the government could have embarked on costly restructuring exercises to strengthen domestic banks before the entry of larger foreign banks. That it did not reflects policy supportive of increasing integration with Europe at the expense of protection for uncompetitive domestic financial institutions.

Laws are comprehensive for banking, although there are still shortcomings that are being addressed in the insurance sector. There is also a gap in terms of an effective and modern bank resolution framework linked to the ongoing viability of the deposit insurance fund. However, most of the problems in the legal domain relate to court capacity, the absence of precedent consistent with market practices, the traditional anti-creditor bias of many judges, and general judicial capacity weaknesses.

The regulatory framework is firm for banking, although it is less settled in the insurance sector. Weaknesses in banking supervision include the need for more advanced early warning systems, improved reports from the banks, and additional training needs for supervisory staff in new risks that are likely to emerge as the system becomes more competitive and complex. However, for now, the Banking Supervision Department (BSD) has made substantial progress since 1997, and it is viewed as adequate relative to the risks being assumed by the banks at the moment. However, as noted, these are expected to become more challenging in the coming years, and BSD systems and staff will need to adapt. This is considered far more problematic and challenging in the insurance sector, where institutional capacity lags that established in banking.

Accounting and financial information remain relatively weak in Bulgaria, although bankers have managed to adapt credit risk evaluation methods to the environment to reduce the level of non-performing loans. Meanwhile, external auditors have managed to help the banks improve their information systems, and to comply with regulatory standards and reporting requirements. However, the profession has many gaps in it, not the least of which is the small number of chartered accountants in IAS and auditors in ISA. Most registered firms still follow tax-oriented practices, and many bankers are still unable to lend (even when they know a firm is a good credit risk) because of the violation of underwriting standards that would ensue.

Otherwise, developments are fairly positive. Bulgaria is moving to Real Time Gross Settlement in 2002. While the BNB credit registry is not as comprehensive as bankers would like, they do use it. This is an advance from 1997-98 when the system did not even exist. Private rating agencies have rated a handful of banks and insurance companies, and this may increase in the coming years if Bulgaria is successful with structural reform. The financial media appear reasonable, and many regulators and market players have web sites to broaden public disclosure of information. There are several active associations that are playing a constructive role in legislative/regulatory reform and policy discussion. Improvements in telecommunications are making it possible to move on with needed modernization of MIS, IT, and electronic banking.

Score: 3

1.1. Policy/System

Bulgaria showed significant progress in 1997 after economic collapse in 1996. **Policy has been geared to stabilizing the macroeconomic framework**, with evidence of this in the form of relatively low inflation rates (notwithstanding the 2000 increase), fiscal discipline, satisfactory levels of foreign exchange reserves to sustain the currency board arrangement, and responsible debt management that has maintained international confidence in the underlying economy. The proof of this confidence is in the relative lack of concern about problems in Turkey spreading to Bulgaria (apart from a potential minor change in export earnings), which differs substantially from the contagion effects that have affected investor sentiment in other emerging markets.

Nonetheless, while the previous government was committed to establishing an environment conducive to market development (with partial success), **it was not as successful in implementing structural reforms in the real sector**. Numerous problems have surfaced in the realm of privatization and corporate governance. In the financial sector, judicial capacity weaknesses have been exposed with regard to bank resolution, while accounting and financial information weaknesses persist due to poor (and manual) internal systems, fragmented intra-bank reporting, and lack of experience with risk-based management reports. In general, there is a view that government policy is undermined by weak information, a lack of depth in understanding the complexity of financial sector issues, and relatively thin capacity below senior levels in the implementation of new laws and regulations. Overall, there is a sense that reforms are reactive, causing significant cost and burden to the system, undermining needed certainty for investment, and generally lacking in medium-term vision. The new government will face these challenges, and progress in reversing such weaknesses should correlate with a rise in growth and competitiveness.

In addition, **Bulgaria faces the challenge of correcting structural imperfections. This can be done with time, particularly if there is a cohesive strategy that more effectively harmonizes the legal, tax and institutional framework for modern financial services**. In general, government policy has been supportive of development of a market-based system since 1997. The invitation to enter negotiations for EU membership will help to consolidate gains, and provide incentives for difficult decisions that will need to be made in the coming years.
Score: 3+

- **The political environment had stabilized by late 1997 into early 1998**, largely on the strength of fair elections and the rapid effectiveness of the currency board arrangement in bringing down inflation rates. This stability and urgency permitted the introduction of key banking legislation and a strict prudential framework for banking. **Since then, financial markets have stabilized**, even though real sector and judicial weaknesses and tight purchasing power limit the earnings opportunities for banks. Relatively low levels of financial intermediation, weak purchasing power, concerns about corruption in public administration, and continued poverty experienced by much of the population have all translated into relatively low confidence levels of the public in most registered political parties[1] leading up to June 2001 elections. However, confidence levels in the currency board arrangement remain high, and there is virtually no risk that the newly elected government will radically deviate from general stabilization policies.

---

[1] See "Early Warning Report," UNDP, March 2001, and *The Sofia Echo*, May 4-10, 2001.

- **General international relations are sound, although Bulgaria faces regional risks due to political instability**. Bulgaria joined the WTO in late 1996, and was invited by the European Union to commence formal negotiations of accession in late 1999. With regard to the latter, Bulgaria signed the Europe Agreement in 1993 to regularize trade between the EU and most non-CIS transition economies. By 2000, about half of all international trade was with EU countries. As of early 2001, Bulgaria had provisionally closed eight of 31 chapters in EU accession negotiations, which is less than all other candidates except Romania. Bulgaria has opened negotiations on key areas such as free movement of capital and competition policy. Bulgaria is also a member of EFTA and CEFTA, which has provided for free trade arrangements with 10 countries accounting for about 10 percent of total 2000 international trade. Bulgaria has similarly expressed an interest in joining NATO, and recently signed a bilateral agreement (March 2001) that provides for NATO transit, the stationing of NATO forces, tax and duty preferences, and the use of transport infrastructure and radio wave frequencies. Bulgaria is also a signatory to the Balkan Stability Pact. While international relations are generally sound, there have been recent disputes with Russia, and cross-border skirmishes between Kosovar Albanians and FRY Macedonian forces have raised tensions in the region. While the FYR Macedonia-Kosovo conflict is not Bulgaria-specific, this could deter some hoped-for investment, particularly given concerns in the EU about a slight slowdown in economic growth. There is also the remote risk that economic problems in Turkey could adversely affect Bulgaria's current account, although this is mitigated by limited financial sector linkages[2], and the high proportion of electricity exports from Bulgaria that represent a critical import for Turkey.

- **With regard to legal and regulatory reform in the financial sector, there was significant activity in 1997-98[3], with several amendments and some key new legislation adopted since**. Key areas involved the introduction of the currency board in July, 1997, passage of revised banking legislation and prudential norms in late 1997, acceptance in late 1997 of a proposed privatization program for enterprises and banks, and adoption of deposit insurance fund legislation in 1998. Amendments have been added since to all of this legislation. Bulgaria has also established a registry for pledged moveable assets, the BNB has established its credit information registry, and banks are now audited based on international accounting and audit standards. Recently, parliament was on the verge of passing a bank bankruptcy act in early 2001, although it did not pass in the end. Significant weaknesses remain with regard to the judiciary and enforcement of existing laws. This is partly due to the backlog of cases, poor organization of caseloads, and traditional bias of many judges in favor of debtors against creditors. This has reduced incentives for creditors to lend, particularly to SMEs and other firms that do not have a documented credit history. The draft law on bank bankruptcy would have advanced the framework for bank resolution, including providing the Deposit Insurance Fund with managerial responsibility for the performance of trustees in bank bankruptcy, rather than the current court-oriented process that has proven to be slow and costly. Such issues will

---

2 Turkish banks only account for about 1 percent of Bulgarian banking system assets and are not reported to be large suppliers of trade guarantees.

3 A 1997 review by the European Commission indicated that Bulgaria had stable democratic institutions, but that weaknesses remained with regard to public administration. The Commission recommended particular focus be directed towards the fight against corruption, financial sector restructuring, telecommunications, taxation, statistics, consumer protection and customs. Many of these recommendations have been carried out, including in the area of financial sector reform.

need to be addressed and reformed in the near future to sustain confidence, particularly in the next round of market development that is expected to involve greater risk-taking by banks.

- **Economic developments have been broadly favorable since 1997 after Bulgaria emerged from collapse in 1996. At a minimum, there is widespread recognition that 1997-2000 has been a period of stabilization, with comparatively high growth registered in 2000**. Key macroeconomic indicators—inflation rate, exchange rate, fiscal deficit—all stabilized in 1997, largely predicated on the successful introduction and rapid stabilizing effect of the currency board arrangement. The previous government sustained monetary discipline by containing fiscal deficits to less than 1 percent of GDP since 1998. Moreover, Bulgaria was able to attract about $1 billion in foreign direct investment (FDI) in 2000—half of Bulgaria's cumulative FDI since 1992 was in 1999-2000—and there is increasing investment in productive enterprises as well as financial services. This points to future competitiveness in export-oriented sectors, higher levels of financial intermediation, and a broader array of financial services for the corporate and household sectors of the economy. However, the registered unemployment rate has increased from about 14 percent at end 1997 to 18 percent in 2000. Inflation rates increased to year-on-year 11.4 percent in 2000 due to rising dollar-denominated commodity prices (due to high levels of energy imports). At the household and small business level, purchasing power remains low. About 35-40 percent of GDP remains informal, triggered largely by tax avoidance, tax aversion, and in some cases, outright corruption.

- **There has been major progress in the banking sector with regard to stabilization and privatization**. All the major banks have been privatized, mainly with strategic foreign investment. Only four banks remain state-owned, and there are plans and discussions already under way for two—Biochim and Central Cooperative Bank—although there is no guarantee either with be successfully privatized in 2001. A third bank, DSK (the former state savings bank), has been successfully brought under control in recent years, although its privatization is not planned at the moment due to restructuring needs. A fourth bank, Promotional Bank, was introduced in 1999 to facilitate SME financing. There are concerns that this last bank could be used to distort the market via subsidized rates on loans and easier terms and conditions. There are also risks that it could be used as a tool for connected lending. Meanwhile, the degree of concentration in banking has diminished in terms of assets, deposits and capital. Competition has increased, and financial information is better than existed prior to 1997. BNB has been effective from a supervisory role in maintaining regulatory discipline in the system while banks stabilize and recapitalize. Confidence in the banks' capacity for safekeeping appears adequate, with deposits increasing. Bank capital and liquidity ratios remain high. In fact, the market view is that the banking sector is overcapitalized, with 36 percent capital adequacy for the system at end 2000. Nonetheless, lending levels remain relatively low as a result of weaknesses in the real sector. These include time and cost problems associated with the enforcement of loan agreements in the event of default. While improvements have been and are being made with regard to legislation and the judicial framework, the system is still not sufficiently creditor-friendly for banks to want to lend while net spreads on other investments generate higher returns relative to risks assumed. What is likely to spur lending is an increase in banking sector competition (which is occurring in the corporate market), recognition of the need to identify new markets to increase earnings (which is occurring as banks tool up for retail operations), and more complete information and better business proposals from private sector borrowers.

- **There is still limited competition from non-bank financial institutions, although the insurance sector is starting to show growth**. Legislation prevents banks from entering the insurance market directly, although it is anticipated at some juncture in the future that *bancassurrance* and other approaches to cross-selling will emerge. The insurance market has mainly shown growth in motor vehicle, although other forms of insurance such as property and casualty are increasing as a result of foreign investment. In this case, foreign firms have sometimes borrowed abroad for investment in Bulgaria. Conditions of their financing often include insurance-related provisions. Consequently, two of the largest insurance companies in the world—AIG and Allianz—have a presence in the Bulgarian market. Munich Re is also reported to be increasing its activity through its close relationship with Hypovereinesbank. The privatization of the State Insurance Institute is expected in 2001, and this will remove the state from the insurance sector apart from its supervisory/regulatory role. Movement in this direction has been combined with preliminary strengthening of insurance supervision. Banks have also teamed up with some of the private pension funds, and more linkage is expected in the form of custodial services and investment intermediation. The capital markets have been poor performers in Bulgaria, with limited equities available and a relatively quiet government securities market that needs limited domestic financing as a result of fiscal discipline and rising FDI. There is no secondary market trading of government securities. Commercial credit, factoring and leasing are limited, with banks providing some financing to leasing companies. Mortgage financing exists, but this is not a large market.

- **Anecdotally, there does not appear to be significant socio-cultural or historical enmity towards banking, although most people and many businesses appear to be debt-averse and do not believe they can access credit**. A culture of loan default emerged in the early and mid-1990s, largely in the state sector and among privatized companies that operated according to earlier practices—rollovers, insider transactions, and other practices that can undermine financial sector stability. There also appear to be traditional household views that oppose debt as a basis for financial management. At the household level, this is often prudent due to the limited or unreliable sources of earnings that many people have. At the same time, it is expected that the view of banks and banking will become more favorable over time as banks expand the array and delivery of retail services. The introduction of debit cards, internet banking and tele-banking represent a beginning in this domain. This is likely to expand as the upgraded payments system takes hold (likely in 2002), payroll services are run through bank accounts, credit cards are eventually issued, and non-bank products (e.g., insurance, pension fund) are made available at bank branches. However, more favorable views of banking will also depend on maintaining confidence in the safety of deposits. This will be predicated on continued financial discipline from both the market and from the regulators.

1.2. Legal

Major financial sector legislative reform was achieved in 1997 and has been broadly sustained. There are few reported problems associated with banking and insurance legislation by industry practitioners themselves. However, there have been problems and weaknesses associated with the regulatory/supervisory process (in insurance, which is underdeveloped compared to banking) and with judicial processes.

Banking legislation is broadly viewed as effective, although there will be calls for increasing permission from the regulatory authorities to permit banks to enter non-bank activities. This will have to proceed cautiously, although banks with demonstrated capacity and competence from more developed markets should clearly be permitted to move forward in these fields. In the insurance sector, legislation is evolving in line with EU standards.

Insurance sector legislation and regulatory capacity have much further to go in terms of capacity building and implementation as compared with banking. In some ways, permission for banks to enter insurance needs to be pursued cautiously to allow the regulatory authorities to develop the capacity and systems for an orderly insurance market to function.

Meanwhile, **bank resolution represents a critical weakness in the legal framework**. There have been bank closures, but 10 failed banks remain to be definitively resolved. Bank bankruptcy is a court-oriented process in Bulgaria, and is often protracted due to the role of judges and trustees in the process. This often is time-consuming, costly, and of questionable effectiveness with regard to the liquidation of assets. Recent efforts to reform this process stalled in parliament and eventually did not pass[4]. A more efficient, transparent process for bank resolution will need to be in place as a future contingency.

Other changes have recently been adopted, most notably improvements in the Civil Procedure Code to strengthen creditors' rights, mainly in the area of collateral collection. However, here as well, there are problems associated with control of collateral resting with the debtor during periods of dispute, as well as problems related to perfection of liens on securities as pledge registration requirements pertain to the holder of the securities rather than the securities themselves.

There are also concerns about the frequency of amendments and changes to laws, as frequent legal changes can reduce certainty needed for investment and risk-taking. However, in fairness to the previous government, changes in legislation often resulted from consultations with and recommendations from market players. This is partly driven by EU accession criteria and the greater sense of urgency the government now places on complying with EU directives. **Score: 3**

- **The legal framework is broadly viewed as satisfactory by the banking sector, although judicial capacity and enforcement are not**. Bulgaria revised and amended a series of laws in mid-1997 to pave the way for the introduction of the currency board. In the banking sector, key laws include the Law on the Bulgarian National Bank (June 10, 1997 and subsequently amended in 1998 and 1999), the Law on Banks (July 1, 1997 and amended in 1998, 1999 and 2001), and the Law on Bank Deposit Guaranty (April 15, 1998 and amended in 1998 and 1999). Other key laws in the financial sector include the Foreign Exchange Law (September 8, 1999), the Law on Redenomination of the Bulgarian Lev (February 19, 1999 and amended in 1999), the Law on the Measures against Money Laundering (July 9, 1998 and amended in 2001), the Law on Securities, Stock Exchanges

[4] The draft bank bankruptcy law would have provided a clearer basis for oversight of trustees in the disposition of assets, assigning oversight responsibility to the Deposit Insurance Fund.

and Investment Companies (June 29, 1995 and amended in 1996, 1997, 1998 and 1999), the Insurance Act (1999, amended in 1999 and 2000[5]), and the Social Voluntary Pension Insurance Act (January 1, 2000).

- **The Law on the Bulgarian National Bank (BNB) brought central bank legislation in line with the currency board operation introduced formally on July 1, 1997. Additional laws and amendments have been made to account for a more open current and capital account, lev redenomination, and money laundering**. The focus of the Law on BNB has been on currency stability and the effective functioning of the payment and settlement system[6]. Based on the Law, BNB (i) has the exclusive right to issue notes and coins; (ii) is responsible for the regulation and supervision of Bulgaria's banks; (iii) is empowered to set reserve requirements; (iv) addresses systemic risk; and (v) limits the lender of last resort function of BNB, curtailing much of the refinancing of banks that led to collapse in 1996[7]. The 1997 law clarified the currency board operation overseen by BNB, and fixed the exchange rate at BGL 1,000:DM 1. The subsequent redenomination of the lev was enshrined with the *Law on Redenomination of the Bulgarian Lev*, essentially bringing it to parity with the DM and Euro. The *Foreign Exchange Law* further liberalized the current and capital account, allowing for the virtually unrestricted flow of foreign currency in to or out of Bulgaria on the condition that reporting requirements are met. More recent legislation (*Law on the Measures against Money Laundering*) has addressed financial fraud and crimes in conjunction with international efforts to combat money laundering. This (i) applies to BNB, banks, other financial houses, and exchange bureaus; (ii) includes identification of transactions equal to or in excess of 10,000 leva, or multiple transactions that equal/exceed 30,000 leva; and (iii) notes international cooperation requirements.

- **The Law on Banks is a strict law that covers essential requirements in accordance with international standards**. The Law details licensing requirements and capital requirements, limits on large loans and loans to connected parties and insiders, disclosure requirements, internal and external audit requirements, supervision and regulatory oversight, conservatorship, bankruptcy, and liquidation. Key provisions include (i) minimum paid-in capital of 10 million leva[8]; (ii) reserves at 1.25 percent or more of total assets and off-balance sheet liabilities; (iii) large loans in excess of 25 percent of bank capital must be fully collateralized by gold, convertible foreign currency, or lev deposits blocked at the bank; (iv) total large loans cannot exceed 800 percent of the bank's "own funds" or core capital; and (iv) total loans to connected parties and insiders cannot exceed

---

5 Information on the insurance sector is partly derived from the 1999 annual report of the insurance supervisor, currently named the State Insurance and Gambling Supervision Agency. It is possible that amendments were made to the Insurance Act prior to 1999.

6 The law sets "maintenance of the stability of the national currency through implementation of [the] monetary and credit policy…and functioning of efficient payment mechanisms" as the main task of BNB.

7 Article 33 of the Law notes that BNB refinancing of banks is limited to periods of liquidity risk that may affect the banking system. Refinancing can only be to solvent banks in lev-denominated credits with maturities not exceeding three months. These credits are required to be fully collateralized by gold, foreign currency or other highly liquid assets. The total value of these credits cannot exceed the lev equivalent of gross international foreign exchange reserves over the total monetary liabilities of BNB.

8 This equals DM 10 million at official exchange rates, and approximates EU minimum capital requirements of E 5 million.

10 percent of paid-in bank capital. From 1997 on, banks' annual reports were required to conform to IAS. This has generally been complied with, and provisioning standards have been brought more in line with international standards to allow for more accurate classification of loans, more timely recognition of problems, and stronger capital positions. The legislation places significant responsibility on the banks to introduce strict procedures for governance and management to ensure banking system stability. Banks appear to have done a much better job of this than the real sector.

- **The Law on Banks provides for bank "bankruptcy", specifies the hierarchy of claims on assets in such cases[9], and has been amended to include provisions regarding liquidation and receivership. However, these measures have proven to be inadequate in practice, and they point to underdevelopment of the overall resolution framework in the banking sector**. At least 10 banks that were closed down in 1996-97 have still not been definitively resolved. This has produced criticism of the court-oriented process, including the lack of commercial training of judges, the non-transparent management and contracting standards employed by trustees, and delays that have drawn out costs and depleted cash. While this is not a major problem with regard to the currently licensed and operating banks, it does point to the need for a more professionalized, accountable and efficiently managed resolution process. Given the poor reputation of a handful of existing banks, the low aggregate capital of some of the Group IV banks, and the possibility of consolidation for market-based as well as regulatory-based reasons[10], a modernized resolution framework will need to be established at some juncture.

- **The Law on Bank Deposit Guaranty was introduced in 1998 to establish an explicit guarantee function, and to rebuild confidence** with the intention of restoring funding back to the banking system. The scheme applies to all banks with a license to mobilize deposits in Bulgaria, including branches of foreign banks where deposit schemes do not exist (or apply to branches abroad), or exist at lower levels of coverage than in Bulgaria. The scheme is graduated in terms of coverage[11], and effectively provides up to 6,900 leva in coverage. One of the key challenges Bulgaria will face in the next several years is aligning its coverage with EU guidelines, which call for about Euro 20,000 in coverage, or nearly six times current levels of coverage in Bulgaria. It is likely that a transition period will be permitted to achieve this, rather than achieving full coverage so rapidly (by the time of accession, currently envisioned some time later in the decade). Since the Deposit Insurance Fund (DIF) has been established, banks have paid fees on the order of 100 million leva at a 0.5 percent rate of year-end deposits. There are several problems with this formula, not the least of which is that its capital and reserves account for only 1.4 percent of total deposits in the system, while about two thirds of all banks have fewer than 100 million leva in deposits. This means that, in the event of a bank failure, DIF would need to

---

9 These are as follows: claims secured by collateral or a mortgage; claims involving foreclosure; bankruptcy costs; deposit insurance claims; uninsured deposit claims; banks' claims; social insurance obligations; payment arrears to the State and municipalities; and all other claims.

10 Many smaller and more open markets have moved towards a reduction in the number of banks to ease the supervisory burden, and relied on the presence of foreign banks with reporting responsibilities to their host country supervisors to reduce the risk of domestic market instability. For example, Estonia, another currency board country, has moved in this direction.

11 95 percent of the first 2 million leva are covered, followed by 80 percent of deposits between 2 million leva and 5 million leva.

increase premiums from banks[12], demand advanced payment of future premiums, and subsequently borrow funds from the National Assembly. Because these are undesirable and reactive approaches to a larger problem, a more efficient means of purchase and assumption and asset resolution will need to be devised. This is at the heart of the recent effort to introduce a bank bankruptcy law, which parliament failed to adopt as of May 2001[13]. The proposed law would have provided DIF with greater managerial responsibility and oversight of the activities of trustees responsible for asset sales of a failed bank. This has been in response to the drawn out process to date of court-oriented efforts, and the evident unwillingness of BNB to intervene, as permitted in the Law on Banks[14]. In the future, DIF and the BNB will need more effective and rapid means of liquidating failed banks. The alternative is costly and drawn-out proceedings, and obstacles to DIF achieving rapid payout for eligible depositors.

- **The Law on Securities, Stock Exchange and Investment Companies addresses the regulation of securities and investment activities, the organization of stock exchanges and issuance of licenses, the types and roles of investment intermediaries in public offerings and trading activities, insider information and disclosure, and related aspects to capital markets development**. This has not been particularly crucial to banks (apart from bank brokerages), given anemic levels of turnover and capitalization on the market. Banks' investment activities are restricted in non-bank companies, and investment in government securities has been miniscule as a result of fiscal discipline. This is expected to change over time as Bulgaria eventually moves to join the European Monetary Union, and as banks eventually become more "universal". Harmonizing legislation with EU standards, ensuring close coordination between Bulgarian regulatory authorities—BNB for bank supervision and the Securities and Stock Exchange Commission for capital markets—and implementing close and effective coordination between Bulgarian and foreign regulatory authorities will need to be developed over time. However, for the time being, the securities market is so small that there is little to regulate. Changes to the law have been drafted to improve the level of transparency in the markets, to move to more electronic forms of trading (dematerialization) and archiving, and to ensure better governance for firms operating on the OTC and managing portfolios.

- **The Insurance Business Act and implementing regulations provide the basis for the insurance sector, including supervisory responsibilities, but the system is just beginning to evolve in a market-based manner**. The insurance sector is underdeveloped, and penetration rates remain low, even though there is growth. Regulators are attempting to adopt EU directives and assimilate IAIS standards. In fairness to the supervisory authorities, they have moved quickly to introduce a number of implementing regulations to bring the sector more in line with international norms. However, the effort has been haphazard, with a steady stream of new implementing regulations rather than a mapped out framework for insurance sector development. The law does not grant the insurance regulatory authority autonomy. Rather, it is organizationally housed in the Ministry of Finance, serving as the supervisor on behalf of the National Insurance Commission. The main problems relate to the quality and timeliness of information, underdeveloped capacity

---

[12] The increase is limited to 1.5 percent of the deposit base.

[13] For a comprehensive overview of these issues, see Thompson, Christopher, "Evaluation of Draft Law on Bank Insolvency," Barents Group, February 25, 2000.

[14] See Article 89 of the Law on Banks.

to enforce policyholder protection, and general institutional weaknesses resulting from inadequate systems. External auditors are not required to audit the accounts of insurance companies, which triggers tax-oriented reports that may not be consistent with solvency, liquidity and disclosure standards required by international norms.

- **The Mandatory Social Insurance Code was passed in 1999 and officially adopted on January 1, 2000. This paved the way for a regulated three-pillar pension scheme to replace the largely PAYG system that was viewed as fiscally unsustainable**. While voluntary contributions began in 1994 with adoption of the Social Voluntary Pension Insurance Act, the system continued to run largely on the basis of the traditional PAYG system. The reformed code and system provides for three pillars of social insurance, namely the defined benefits PAYG system (first pillar), the supplementary mandatory contribution system (second pillar), and the voluntary system (third pillar). The focus of the pension reform is on building a sustainable social insurance system for people born after 1959. Pension funds are supervised by the insurance supervisory authority. A number of regulations have been introduced to provide for licensing and supervisory requirements, pension fund management and investment policy, consumer protection, fee structures, solvency and liquidity requirements, accounting and reporting, and related components of modern pension system regulation and management. Banks are permitted to have ownership stakes in private pension funds, and at least of four of these funds had direct investment from Bulgarian-licensed banks in early 2001, with at least one more in process[15]. Many banks also play a critical custodial role, and most funds have at least two custodial agents. Custodial capacity is thought to need improvement for increased participation in the voluntary third pillar.

- **Secured transactions have increased as a result of increasingly effective use of pledges on moveable properties, promissory notes and other collateral**. The Registered Pledges Act came into effect in April 1997, allowing for non-possessory pledges on movable properties by “merchants” or “traders” on the condition that written agreements are registered with the central registry. Pledges can be enforced without court involvement. Banks have effectively taken pledges in the last couple of years, and the registry appears to be effective. However, the Law on Pledges does not apply to immoveable properties. This undermines larger and longer-term lending, which stifles new investment in the absence of functioning corporate bond markets. Meanwhile, several problems remain with regard to the Registered Pledges Act, namely that collateral remains in possession of the debtor, the perfection of liens on securities is difficult (given turnover and the need for constant re-registration), and liquidating these assets is reported to be difficult.

- **Judicial capacity weaknesses persist as a major problem and deficiency in the modernization of financial markets in Bulgaria**. Part of the problem is the general lack of a comprehensive framework for financial sector modernization. Traditional civil procedures, ever- changing laws, and the absence of experience and precedent in a market economy have made it difficult to resolve commercial disputes. Low pay, weak

[15] These included (i) Postbank, Bulbank and UBB in the Bulgarian Pension Insurance Company; (ii) Teximbank with a very small stake in PIC Newton Sila; (iii) DSK in SCPIC Rodina; and (iv) Bulbank in PIC Saglasie. In addition, ING was planning to invest in a pension fund in the first half of 2001. Deutshce Bank, which does not have a bank license in Bulgaria, has a stake in PIC Doverie through its joint venture insurance company with Cardan/Taladium Israel (TBI).

administration, excess responsibility, dubious notary practices (in some cases), and corruption have all added to a risky legal environment. Courts have been unable to expediently process case loads because commercial law was only introduced in 1989, receivership problems have overwhelmed court capacity, and new laws have not always been fully reconciled with earlier laws and codes. Bulgaria's legal infrastructure suffers from a shortage of specialized judges and courts to handle bankruptcy proceedings. Out-of-court approaches involving creditors and debtors are undeveloped, and arbitration procedures have not yet been effectively introduced or implemented. In general, commercial cases take up to one year to be heard. Two to three years are required for final judgment for payment, and the amount of payment to be made.

- **Weaknesses in bankruptcy, liquidation and reorganization processes and procedures have also stifled development of certified liquidation and valuation professions**. There appears to have been very little progress on this front apart from favorable developments regarding registered pledged assets. However, there is still the practical problem of the timing of asset repossession, due to time elapsed through the court system. By the time repossession is authorized, assets have often been stripped or damaged. This could be remedied by placing a bond on the assets to secure their quality and clarify claims.

1.3. Regulatory/Supervisory

The laws on BNB and banks have provided for a tightly regulated banking environment to guide Bulgaria through its stabilization process following the events of 1996. BNB has a clear mandate to license, regulate and supervise banks, and it has acted on this mandate since 1997. However, bankers criticize the process as being excessively rules-based, heavily data-oriented, and sometimes inefficient because of the lack of harmonization of regulatory reporting requirements with existing internal systems. In some cases, the communications process has been criticized as being deficient, tardy and incomplete. Given the frequency of regulatory changes, this is disruptive and costly to bank operations. Nonetheless, net of these kinds of criticisms, the banks appear to recognize the strong mandate BNB has to supervise the system.

The Law on Banks is explicit and clear in spelling out requirements of banks within the regulatory framework. Moving forward, **the challenges faced by BNB and Bulgaria's banks relate to moving from a narrow, risk-averse focus on stabilization to a system that is more competitive, generally privately-owned, and driven by the need to generate stronger and more diverse earnings streams for better returns**. With several large foreign banks now present in Bulgaria, competition has already begun in the small corporate sector. Most banks are now embarking on development of retail strategies, including movement towards packages and more complex instruments that have the potential to generate far higher earnings. On the other hand, several banks (among them smaller and largely domestic banks) may be lagging the more dynamic banks in terms of investment in new technologies, development of more suitable MIS, and general market experience. This presents the risk that smaller banks may not be able to compete, or that the less competitive banks may seek to generate higher earnings predicated on strategies that are excessively risky and dangerous. At a minimum, **consolidation can be expected as market development proceeds**. Should this occur, Bulgaria will need to move forward with a more appropriate resolution strategy that is fast, least cost, and consistent with rapid deposit payout.

Beyond that, **banking supervision will need to strengthen its early warning systems** to ensure that issues of adverse selection or large concentrations in the inter-bank market do not undermine general system stability. **Many banks will need to further improve their governance, including internal audit, and general management capacity**. **Score: 3**

- **The Law on the Bulgarian National Bank is clear about the legal mandate of BNB in licensing and supervising banks**. Banking supervision constitutes one of three departments of BNB[16], and it is empowered with tools needed for effective oversight and intervention. The Banking Supervision Department (BSD) is overseen by a member of the Management Board who is also a Deputy Governor. There are strict standards and penalties related to commercial confidentiality and conflict of interest. It is uncertain if the strictness of penalties serves as an impediment to bolder action concerning bank closures, or other areas of restructuring and reform. Nonetheless, there is broad consensus that banking supervision has improved in the last several years, notwithstanding continued weaknesses in several key areas (e.g., bank reporting, early warning systems).

- **Licensing requirements for banks are well detailed**, and include articles of association, information on paid-in and subscribed capital, business plans, documentation on board members, and detailed information on all shareholders with at least 3 percent of capital (including verification that capital investments in the bank are equity-sourced, and not

[16] The other two are the Issue Department (currency board) and Banking Department.

based on borrowings). For foreign bank branches, it also includes written consent of the bank supervisory body of the bank's domicile country. For large shareholders, information requirements include tax status as well as method of payment for shares. Borrowings for investment in capital are not permitted, although they are reported to be the case in some instances. Written permission is required from BNB for acquisition of more than 10 percent of voting shares in a local commercial bank. For foreign banks, licensing criteria require that these banks be prime-rated (or guaranteed by prime-rated banks) and supervised on a consolidated basis by competent authorities in the foreign banks' respective countries of domicile. The law also forbids foreign banks from engaging in activities that are not permitted in the banks' respective home markets. "Free" licensing of EU member banks was expected to begin in 1998. There have been no reported problems encountered by EU member banks, of which several have invested in Bulgaria in the last few years. One current licensing application by an EU/international mix of investors has reported it expects to receive preliminary approval on a prompt basis, and a final license well within the six months allowed in the Law after staff, premises, the appointment of administrators and other normal prerequisites have been met. More general rules for rejecting (and revoking) licenses or activities for domestic and foreign banks are also included.

- **Both the Law on the Bulgarian National Bank and the Law on Banks provide a clear legal basis and mandate for BNB to supervise the banks. However, for major instances of non-compliance, it is unclear how efficient BNB has been in detecting these violations, and how firm it has been in punishing serious violations**. Supervision relies on both on-site inspections and off-site surveillance, with technical assistance being provided to assist with the development of policy, strategy, management, systems, and effectiveness. There are about 80 people employed in supervision, of which approximately 21 are in the on-site inspection department and another 21 are in the off-site surveillance department. The Law on Banks provides significant detail on the corrective actions and penalties that banks face in the event they are perceived to be out of compliance with prudential regulations. These actions include but are not restricted to forcing banks to increase capital, disallowing dividend payments or the distribution of capital, forcing specified shareholders to transfer shares, appointing auditors and conservators, and revoking licenses. None of these enforcement actions can be appealed to a court.

- **Banking sector regulations are broadly consistent with international norms, apart from mandatory collateralization to avoid automatic provisioning**. These include bank licensing, payments, foreign currency positions, government securities transactions (including in long-term ZUNK bonds), commercial paper, large and internal loans, capital adequacy, risk-based provisioning, internal controls, liquidity management, collateral sales, payments issued by debit/credit cards, and deposit insurance. Electronic signatures and revised RTGS regulations will be introduced over the next year or so. The authorities have generally made an effort to harmonize regulations with international standards. That effort will continue and be consistent with EU directives. Key aspects of regulations include (i) minimum capital ("own funds") of 10 million leva, roughly equivalent to the EU minimum of Euro 5 million; (ii) reserves must be at least 1.25 percent of total assets and off-balance sheet items; (iii) minimum capital adequacy of 12 percent, which is higher than the EU 8 percent, but consistent with BIS guidelines to factor in higher levels of market risk in places like Bulgaria; (iv) a limit of 25 percent above own funds for open foreign exchange positions in any particular currency, and 60 percent for all foreign currencies; (v) parameters for large exposures at 10 percent of capital, and total large exposures allowed at eight times capital; (vi) strict provisioning standards for past due loans; (vii) collateral requirements exceeding 100 percent of loan value to avoid mandatory provisions; (viii) full collateral backing in liquid assets for loans exceeding 25 percent of bank capital; (ix) reversal of interest income from bank revenues on loans overdue more than 90 days; and (x) a freeze on dividend payments until reserves are fully financed at 1.25 percent or more of assets and off-balance sheet items.

- **While regulations are acceptable and consistent with international norms, there are imperfections in terms of application**. One example is the overstatement of reserves due to fewer charge-offs than would ordinarily occur. Another is the problem of asset valuation and risk weighting, which may lead to an overstatement of capital adequacy ratios. Thus, Bulgaria has a solid legal and regulatory framework for stable banking, but there are reported problems with application. There are also reported to be problems associated with BNB communications with the banks, and with errors in reporting. These problems will need to be remedied as banks begin to assume more risk and engage in more complex transactions.

- **Mechanisms are in place for the effective sharing of information with other country regulatory authorities, the Deposit Insurance Fund, and other domestic regulatory authorities**. These are based on informal arrangements with other country regulators, and mandated in the Law on Bank Deposit Guaranty for DIF to determine assessments owed by the banks into the Fund. There are also arrangements between BNB with insurance and securities regulators. These will become increasingly important as banks diversify their activities.

- **BNB will need to ensure that non-banks are not used as vehicles for intermediary practices that could be damaging to systemic stability. This will require norms of coordination with other financial services regulatory authorities in Bulgaria and regionally**. Currently, the Law on Banks does not apply to smaller cooperatives and other such institutions. While not well developed in Bulgaria, the authorities will need to ensure that financial institutions operating in the market do not engage in practices that could distort the market. Examples of this in other markets are cooperative banks that promise to pay significantly higher interest rates on deposits to increase funding, only to be discovered later to be engaged in pyramid schemes. Such approaches can also apply to brokers making false representation on savings products. In these cases, the banks or brokers are often not supervised by the regulatory authorities. BNB and other financial regulators will need to ensure these practices do not occur. This will require that Bulgaria's financial regulators also have systems and protocols established for the exchange of information on potentially destabilizing cross-sectoral risks.

- **Banks are restricted from investing more than half of their own funds (capital) in non-bank companies, real estate and other tangible fixed assets. Combined investments in these areas cannot exceed total bank capital (own funds)**. However, excluded from this tally are assets and equity participations in non-bank companies resulting from secured transactions that transferred to the bank's balance sheet to avoid bank losses. Banks are obligated sell/divest these assets/equity within two years.

- **The banking laws do not include insurance as a permissible activity for banks**. However, the Law on Banks does provide banks with the right to engage in business transactions that make it possible for them to collect on the loans they have made. This has been used by some banks to attach insurance requirements to collateral as a condition for loan underwriting and disbursement. Thus, while not openly cross-selling, some banks are entering the insurance market on this basis. Insurance companies are permitted to own shares in banks.

- **There is increasing disclosure of information in the banking system, yet the quality of information is often questioned**. BNB has the right to access any and all information deemed necessary to carry out its supervisory responsibilities. However, there are reported to be numerous problems within many banks with regard to manual processing of information, weak internal accounting, and mechanical compliance with regulatory requirements. Reporting forms are inadequate, and excess data creates problems of review and analysis by BSD. Information is often returned to banks due to errors and omissions. There are also general differences in financial information reported during the course of the year, and the results from audited statements. While the trend is improving, many banks have had to make major adjustments to their provisions once IAS/ISA are applied, leading to modified profitability and capital figures.

1.4. Payment System

The Law on the Bulgarian National Bank states that "establishment and functioning of efficient payment mechanisms" is a function of BNB's main task, which is currency stability. Investment in this area as far back as 1992 to protect BNB from unintended overdraft credit and to provide low cost and prompt settlement indicates that Bulgarian banking and monetary authorities appreciate the importance of the payments system to economic stability. There were no major problems reported with the payment and settlement system as is, even though it is not designed to handle large value payments, settlement sometimes takes as long as three days, and banks do not know their exact balances until 10:00 a.m.

More recently, the government decided to accelerate movement towards Real Time Gross Settlement (RTGS) to come closer to meeting EU criteria for eventual monetary union. RTGS is expected to be achieved by mid-2002, and this will provide a number of benefits to the system, including opportunities for more electronic applications of banking (e.g., electronic signatures, e-commerce, internet banking) and more efficient liquidity management. **Score: 3+**

- **The government has opted to accelerate progress and move towards RTGS**. This is expected to be achieved by mid-2002 if an off-the-shelf product is purchased (as planned by mid-2001). If a system is to be built domestically, the introduction of a modernized payment system will take longer.

- **According to the regulation on payments, banks have mandatorily participated in BISERA unless the BNB managing board decides to exempt banks from participation**. Payments through BISERA have been registered on the day received, and in the order of receipt. Payments are effected within one to three working days. The regulation addresses measures to correct any default in the payment process. The focus of the system is to keep documents for payments in arrears as low as possible to avoid possible settlement problems—not in excess of 10 percent of the overall amount during the previous two days.

- **While BNB and bankers believe BISERA to be efficient and reliable, it is possible that such success has undermined management, MIS and technology development in this area by providing an incentive to banks to defer efforts to improve their own internal systems, procedures and controls**. This appears to have been the case in many domestic banks, as indicated by the manual processing of reports, the apparent frequency of errors in producing regulatory and other reports, the fragmentation of internal systems, and the broad weakness of MIS.

1.5. Accounting

Accounting standards have improved in the financial sector, although it remains a broad weakness in the real sector. Accounting in the enterprise sector is still driven by tax considerations, and is generally not used as a tool of financial management and planning. Meanwhile, the accounting and audit profession counts only a small fraction of total practitioners as licensed in IAS/ISA. This is beginning to change, but Bulgaria lacks overall accounting capacity for modern business management.

The move to IAS for bank *annual* reports began in 1997, mainly for the state banks to be privatized. IAS was also required for large enterprises slated for privatization. For banks, the role of the external auditor is formally incorporated into banking legislation. This has been used to identify internal audit, systems and technology needs, along with management standards for their operation. **Based on findings from on-site examinations, most banks have begun to make improvements. However, many of the smaller banks still lack what is needed in terms of information systems**. In some cases, this has to do with human error resulting from manual processing. In other cases, it is due to poor reporting forms, fragmented data processing systems, and overstretched management.

International accounting firms have been involved in assisting Bulgarian authorities in modernizing standards. However, applying IAS in a meaningful way at the structural level for useful management purposes continues to take time, and this has been one of the areas where Bulgaria has not made as rapid progress as is needed. **The prime-rated foreign banks have no problems with these issues. However, some of the Group IV domestic banks are reported to have weaknesses in these areas**. There may also be related problems at some of the remaining domestic banks with large branch networks that rely on manual bookkeeping. **Score: 3-**

- **Banks have officially moved to international accounting standards, although major changes in provisions as a result of external audits reflect the persistent weakness of internal accounting systems at many banks**. The move to IAS actually began with 1996 statements regarding large enterprise privatization. Banks were required to present their statements according to IAS beginning in 1997. However, the absence of accurate data combined with underdeveloped systems has made it difficult to apply such standards. Common weaknesses apart from provisioning relate to asset valuation, particularly in determining a presumed market value in the absence of major market activity (e.g., for fixed assets). This will become an even greater challenge in the coming years as banks lend, diversify products and services, and increase off-balance sheet items. On a positive note, the adjustments made as a result of externally audited statements are diminishing year to year. This suggests that internal capacity is developing, systems are improving, and banks are presenting/using more accurate information throughout the course of the year.

- **The Law on Banks is strict in terms of reporting, and there are several provisions that relate to disclosure**. The Law requires banks, bank groups and financial holding companies to report to BNB on a disaggregated as well as consolidated basis. In addition, it is required that banks be audited by an approved auditing firm, although the standards and requirements for approval are not divulged in the law.

- **There has been some development and professionalization of the local accounting practice, and Bulgarian accounting standards are considered relatively close to IAS as of 2001. However, most accounting information is considered poor and tax-oriented, and this has served as a constraint to lending**. Several donor-supported accounting training programs have been introduced, and there has been organized activity in both accounting and audit standards. Meanwhile, Bulgaria has tightened up on local standards, seeking to adopt more realistic depreciation schedules, and to provide for more information through notes. There has been noticeable progress in the regulated banking sector. However, most enterprises find it costly to present anything but statutory tax statements. The weakness of financial information from audited statements has meant that many banks have not been able to lend because of the inability to comply with internal underwriting standards.

- **All of the Big 5 firms are located in Bulgaria, or at least have representation. However, there are few non-Big 5 firms certified to prepare statements according to IAS/ISA**. This represents a significant gap in terms of market awareness, targeted firm size, needed application of financial and business planning skills, and appropriate auditing standards and costs for the Bulgarian economy. Banks are major customers of the Big 5, not only for tax and audit needs, but also for IT/MIS assistance.

- **Banks appear to frequently change their external auditors**. It is not uncommon in advanced market economies to limit the number of consecutive years during which an external auditor is appointed (e.g., three to five years) for banks, insurance, and other major financial services. However, annual changes raise questions about the totality of access to needed information, and the efficiency of the process for external auditors to gain an intimate understanding of the individual bank's business, practices, procedures, systems and risks. This can undermine the constructive role external auditors are expected to play as part of the effective functioning of financial markets. The Law on Banks stipulates that auditors are expected to assist the bank with their ability and capacity to maintain proper accounting records, to review and monitor the performance of specialized internal control bodies, to make recommendations for their improvement, and to notify the BNB if any activities are being undertaken that could put the bank at risk. The disruption of continuity in the engagement of auditors likely weakens the ability of auditors to achieve these objectives, and very likely drives up the costs of annual external audits.

1.6. Rating Agencies/Systems

There is still little international portfolio investment focus on Bulgaria apart from Brady bonds, which are generally traded in London. The domestic market is practically nil, and financial statistics show that net portfolio flows have been negative since 1998. Given such circumstances, it is all the more impressive that Bulgaria has been able to privatize its banks with strategic foreign capital.

There is still strict observance of confidentiality by the authorities. This undermines disclosure practices, and has kept the BNB credit registry modest in terms of information dissemination. Meanwhile, private rating agencies have played virtually no role apart from a few ratings, mainly on sovereign ratings and a few of the larger financial institutions. **Score: 2+/3-**

- **There has been some international rating system attention paid to Bulgaria**. International ratings on "sovereign ceilings for foreign currency ratings" were provided by Moody's as early as 1997 (and possibly before). The other major international rating agencies[17] have since been engaged in Bulgaria. All three had "stable" outlook ratings for Bulgaria's foreign currency debt ratings. Moody's included bank deposits as "stable" as well. Fitch IBCA Duff & Phelps gave Bulgaria "positive" long- and short-term foreign currency outlook ratings in August 2000. However, Bulgaria is still viewed as "non-investment grade"[18] (along with the Slovak Republic and Romania among EU accession countries) due to persistent structural problems in the economy, including a large public sector and heavy government debt burden. For Bulgaria to become investment grade, it has to convince the market that more progress is being made in moving to a functioning market economy. With regard to specific ratings of banks and insurance companies, UBB received a "stable" rating from Fitch IBCA Duff & Phelps in December 2000, and Standard & Poor's rated AIG Bulgaria "AAA" and Bulstrad "Bpi"[19] as of April, 2000.

- **The Law on Banks assigns BNB with the responsibility of developing an information system on the creditworthiness of banks' customers, subject to strict confidentiality. This domestic initiative was formally introduced in October 1999 in the form of a credit registry**. All loans larger than 10,000 leva must be reported. Banks use this as part of their routine credit risk evaluation process. However, there is a view that it is very limited and transactional in terms of information provided, and that it does not supply enough additional information to help banks assess risk that might be associated with the borrower. This may relate to more traditional practices of non-disclosure as well as confidentiality concerns. Until there is meaningful disclosure, the usefulness of this registry as a tool for banks to utilize in assessing creditworthiness is expected to be limited. There are reported to be measures in process to strengthen the information content of the central credit registry[20].

- **In addition to the BNB credit registry, there are private services that gather information and report on borrowers**. However, these are considered expensive due to the limited market, and difficulties associated with uncovering verifiable risk-oriented information on prospective borrowers. The most prominent group appears to be Vienna-based Credit Reform.

---

[17] Fitch IBCA Duff & Phelps and Standard & Poor's.

[18] For example, see "Rating the Transition Economies—2001," Standard & Poor's, April 16, 2001.

[19] This is one level below sovereign ratings.

[20] See "Letter of Intent and Memorandum on Economic Policies of the Government of Bulgaria" in Article IV Consultation, IMF, March 2001.

1.7. Financial Media

No particular effort was made to assess the financial media. However, there are several newspapers that report daily and weekly figures regarding monetary issues, trade volumes, exchange rates, etc. This is consistent with the improved legal environment for BNB and the commercial banks, and appears to reflect a commitment to increased public disclosure. The reporting appears to be professional, accurate and objective.

In addition, BNB, the banks, brokers, insurance companies, and other financial institutions have web sites that provide information on their status along with commentary. In general, information flows appear to have increased since end 1997. The recent EU report on Bulgaria's progress toward EU accession[21] reported no problems with issues of information and media communications in Bulgaria, including (by extension) in the financial sector. While there are rumors, half-truths, and sometimes unsubstantiated reports, the financial media generally provide a useful amount of information to the public.

The Law on Banks does specify that the dissemination of false information that can undermine the reputation of a bank can lead to a fine of 50-200 million leva—up to nearly $100,000 at end 2000 exchange rates—for media concerns. Higher penalties can be assessed if criminal activity is proved. **Insufficient Basis for a Score**

1.8. Professional Associations

There are many business and professional associations focused on financial sector development. **The Association of Commercial Banks (ACB) is the main banking association,** coordinating with the banks on a number of regulatory issues and working with BNB, MoF and Parliament. ACB also coordinates with the International Banking Institute to provide training to bankers. However, the ACB has been criticized in some cases for not being open and transparent in terms of its efforts to lobby government on behalf of the sector, and for its own appointments and governance practices.

The Bulgarian International Business Association (BIBA) represents the foreign business community, and includes several large international financial services firms, including Allianz and AIG in insurance, 16 of the largest banks, four of the Big 5 accounting/management consulting firms, and other financial firms in leasing, fund management, and development banking. BIBA's recently formulated annual White Paper included a substantial number of recommendations regarding financial services, taxation, privatization, manufacturing, and other areas of concern. The previous government demonstrated the seriousness with which it takes such recommendations by responding point by point in a 52-page tabular response[22].

There is a 29-member **Association of Bulgarian Insurers** focused on professionalizing standards, ensuring competition and a conducive business environment in the insurance sector, and meeting EU requirements by harmonizing legislation and accounting with EU directives. The accounting profession is represented by the **Bulgarian Institute of Certified Public Accountants**. There is also a **Chamber of Auditors**. The securities profession has the **Association of Licensed Investment Intermediaries**, while private pension funds are represented by the **Bulgarian Association of Supplementary Pension Insurance Companies**. **Score: 3-**

---

[21] See "Bulgaria 2000 Regular Report: Progress Towards Accession", European Commission, November 8, 2000.

[22] Both are available on www.biba.mobikom.com

1.9. Academic

No systematic effort was made to determine numbers of courses, students, institutes, or other academic matters. Nor was there a systematic effort to speak with business/management school officials. There are several think tanks that make a significant contribution to banking sector reform and development, and general economic policy. There are reported to be about 65 management training institutes in Bulgaria. However, **management training in both financial services and the real sector represents a major need in Bulgaria**. For the banking sector, this is important directly for an adequate supply of professional staff, and indirectly to have greater confidence in the management skills and teams of companies seeking to borrow. **Insufficient Basis For a Score**

1.10. Miscellaneous

There has been some slow movement towards privatization of the fixed-line telecommunications market. BTC is the fixed-line monopoly, and it is now slated for privatization in 2003-04. **There are two companies operating in the mobile telephone market**, and a third GSM license is expected to be issued by 2002 before BTC's fixed-line monopoly comes to an end. **There has been some development of electronic commerce**, and Bulgaria will soon permit electronic signatures to be used as a stimulus for such transactions. **Safekeeping from a physical and logistical standpoint appears adequate**, and this will improve with movement towards RTGS. However, no systematic effort was made to review this. The postal system still provides payment services for communities that find it difficult to access retail banking services. **Score: 3**

- **Privatization of the Bulgarian Telecommunications Corporation (BTC) has been delayed for years, and privatization is not expected at least until 2003-04**. The previous government was originally going to privatize 25 percent of the company. Subsequently, preparations were under way to float a majority share of 75 percent to a strategic investor, planned for the end of 1998 after regulations for the issuance of licenses were put in place. This was later cancelled, with the government opting to modernize BTC prior to privatization to generate higher proceeds. To induce competition, the government issued licenses for mobile telephone operations. The first was issued to Mobikom in 1999, and the second to OTE (the Greek monopoly) in January 2001.

- **Bulgaria is now beginning to see banking modernization through electronics, as indicated by the introduction of modern retail banking systems, growing issuance of plastic cards, and plans for electronic signatures to permit on-line banking and transactions**. Bulgaria's move to RTGS will further accelerate reforms and modernization efforts. However, Bulgaria still has significant room for increased penetration in a number of retail areas. For instance, as of May 2001, there were only 667,425 debit cards, 8,015 credit cards, and 507 ATMs. For a country with 8.2 million, these are fairly modest numbers. On the other hand, the growth trend is clear when looking at end 2000 and previous year end figures. As banks follow through on their retail expansion plans, these numbers will grow.

- **No effort was made to review safekeeping practices in the banks, postal payment services, or the physical transport and holding of assets and related documentation**. However, the payments system is moving towards RTGS, which will enhance efficiency in clearing and settlement. The heretofore BISERA system was considered effective, with limited float and reduced opportunities for errors related to safekeeping of resources. However, RTGS is expected to be more efficient in handling higher volumes of transactions, processing large value payments, and reducing problems associated with manual processing. It is unclear if postal payment orders and related services will be linked to the payment system, although it would be expected that the postal services will be linked directly or through contract with a bank or other financial agent.

II. ECONOMIC AND STRUCTURAL FACTORS

Overall macroeconomic performance in the late 1990s has shown significant improvement when compared with the volatility and downward trends of the mid-1990s. While overall output has not fully recovered from one year before the transition began, there have been noticeable and impressive accomplishments since the collapse in 1996. **Real GDP growth has been registered for three straight years**, with 2000 having been the best year since the transition began in the early 1990s. While the unemployment rate remains high, the general growth in the economy and recent introduction of measures to make hiring/firing more flexible should help bring down the official unemployment rate. **Pricing stability has been broadly restored** with the currency board arrangement (CBA), as shown in the relatively low inflation rates achieved since 1997-98[23]. **This has been combined with impressive fiscal discipline**, as budgets have been kept largely in balance since 1998. Given the restrictiveness of the CBA, progress on the inflation front could have been undermined by fiscal laxity. This has not been the case.

In addition to relatively low inflation rates, **there has been an increase in broad money and deposit mobilization with the banks since end 1997**. While funds held with the banks are not as high as they were in earlier years, this is largely due to the high proportion of cash transactions that occur. This points to a weakness with regard to compliance with fiscal requirements. Nonetheless, **fiscal revenues are increasing, and the onerous tax burden associated with personnel benefits (e.g., social insurance) and personal income taxes is shifting to consumption-related taxes (e.g., VAT, excise).** Thus, while the informal sector still accounts for a large proportion of activity and tax evasion remains high, there are now signs that fundamentals are improving. The government is in the middle of a tax rate reduction program, and both revenues and expenditure are increasing without incurring deficits exceeding 1 percent of GDP. As the fiscal burden diminishes and banks provide more incentives for households and enterprises to place funds in their institutions, broad money is expected to increase. This will have a positive effect on intermediation trends in the coming years.

Meanwhile, **the balance of payments continues to show positive data and trends**. Current account deficits are still high, but the structure of the deficits point to ongoing retooling for export-oriented competitiveness, rather than wasteful consumption of luxury consumer goods. This is also reflected in growing levels of direct investment, some of which is derived from CEFTA and EU investors in greenfield operations. Bulgaria’s international transactions have increased in volume, including its exports. This is projected to continue as its trade is increasingly integrated with EU markets, now at about half of total trade as compared with about one third in the mid-1990s. Debt management also continues to be adequately conducted, notwithstanding areas that could be improved with regard to exchange rate and maturity mismatches. Foreign exchange reserves provide Bulgaria with about six months of import cover, debt-to-GDP continues to decline, and the market shows no worries about Bulgaria’s ability to meet its international obligations.

Apart from still high levels of tax evasion/aversion, **the main weaknesses in the economy appear to be structural, judicial, and related to the underdevelopment of the capital markets**. While the previous government made significant progress with bank privatization, its enterprise privatization program was less impressive. **The preponderance of management-employee buyouts (MEBOs) has done little to improve enterprise competitiveness, efficiency and**

[23] This process began in 1997, but year-on-year figures show high year-end inflation for 1997 because of the inflationary build-up through 1996.

governance. Likewise, mass privatization has provided some compensation to voucher holders, but has done little to promote economic growth. Banks that still have these enterprises as clients are at risk because of their continued restructuring needs.

Meanwhile, **the capital markets have offered virtually no outlet for most enterprises because they are unable to achieve listing requirements. The markets themselves are non-transparent, and turnover and capitalization figures indicate that there is significant work to be done to activate the markets. This effort should focus on strengthening company performance, and not on easing listing requirements to sub-standard levels**. If the latter approach is pursued (allowing for reasonable differences between primary and parallel markets), the benefits of disciplined markets will not generate the kinds of liquidity needed for markets to operate efficiently in Bulgaria. Private pension funds, life insurance companies and major banks offer the long-term opportunity for institutional investors to help develop corporate bond and equity issues, as well as to serve as a source of demand for government securities once the CBA lapses and Bulgaria joins the EMU. However, this is a long way off. In the meantime, companies themselves will need to address a long list of governance, management and financing fundamentals to be attractive to investors on markets. Development of these markets and linkage with regional markets (e.g., Athens, Vienna) would be helpful for the development of securitized products (e.g., mortgage-backed securities, warehouse receipts, factoring), and for exit mechanisms to be in place for venture capital, turnaround companies, vulture funds, etc. As of now, Bulgaria has fared poorly in this area.

Having mentioned structural weaknesses, which include high levels of public sector employment, **there is still irreversible movement towards a private sector-oriented economy**. The general estimate of private sector GDP is about 70 percent. The state remains involved in only a few areas of the economy. Lending to the state sector has virtually disappeared. Thus, while structural weaknesses persist, there is confidence that new investment and increased exports will usher in a more competitive economy based on more sustainable prospects for growth. All of this is in stark contrast to conditions of collapse in late 1996/early 1997. **Score: 3**

2.1. General

Macroeconomic data are broadly positive, and represent improvement from the mid-1990s. Real GDP growth has been steady since 1998, notwithstanding drought in 2000 and a general reconfiguration of the economy since then towards services. Inflation rates have come down to manageable levels from the hyperinflationary period of the mid-1990s. The fiscal accounts are generally in balance. Bulgaria is showing signs of increasing competitiveness, both in terms of labor productivity and in terms of export growth. The latter is impressive considering that its exchange rate is pegged 1:1 with the Euro, thereby providing no flexibility in creating a currency-related advantage to increase exports to its major trading partners. General financial indicators such as debt levels and foreign exchange reserves continue to improve. The latter is partly driven by Bulgaria's increasing ability to attract foreign direct investment, which approximated $1 billion in 2000 for the first time.

Weaknesses are generally at the structural level. Public sector employment remains high, while the unemployment rate also remains high. Informal sector activity continues in the 30-40 percent of GDP range, largely to avoid what are perceived to be onerous tax burdens. Methods of privatization are broadly criticized as having done little to improve competitiveness and efficiency in these companies. Corruption is still pervasive, and many critics believe that some of the larger companies that remain state-owned (e.g., BTC in telecommunications, Bulgartabac) could have been privatized earlier and generated significant proceeds. **Score: 3**

- **Per capita incomes in purchasing power parity terms were about $5,000 at end 1999, depending on the source[24]. These are among the lowest of the 10 transition accession candidate countries**, and about one quarter the average of EU members, as compared with 40 percent in 1989[25]. Preliminary 2000 data show that average annual wages/salaries approximated 2,856 leva (about $1,350), with compensation higher in the public sector than in the private sector[26]. These figures are not adjusted for purchasing power considerations. The highest compensation was found in financial services, public sector utilities, and mining. While low, the figures are starting to show year-to-year growth, a reversal from the early 1990s[27].

- **Officially recorded GDP growth has been positive since 1998, reaching 5.6 percent in 2000. However, growth may not be as strong as is reported from statistics. In some cases, formally recorded growth may in fact reflect some absorption of previously informal activity resulting from better tax collection and lower tax rates**. Real GDP increased 11.6 percent in total from 1998-2000, with services showing steady growth and industry rebounding in 2000 after a decline in 1999. Agriculture was fairly stagnant in 1998-99, and suffered declines in 2000 due to drought. However, that growth has been established for three consecutive years is commendable considering several unfavorable external developments, including (i) sanctions on neighboring Yugoslavia throughout the decade, and the recent war in Kosovo in 1999, all of which had a negative impact on trade and investment in the region; (ii) the financial crises that affected Russia and many emerging markets in 1997-98; (iii) more recent troubles in Turkey; and (iv) high energy prices since 1999. This contrasts with the severe 17 percent output decline experienced in 1996-97, and negative real growth in the early 1990s[28].

- Based on a recent study of transition economies[29], **Bulgaria's 1999 output was about 74 percent of total output one year before the transition process began**. Figures in 2000 may have further reduced the gap between current and pre-transition levels. Considering that Bulgaria's worst year was as recently as 1997[30], this represents a positive accomplishment. Bulgaria is the only non-CIS country that experienced its worst year of output after 1995. Thus, its progress since 1998 has been noteworthy. However, it risks a slowdown in the coming years unless structural reforms are accelerated.

---

[24] The IMF figure cited in the World Economic Outlook Report for October 2000 was $4,812 for 1999 per capita incomes on a PPP basis. The National Statistical Institute and BNB figure was $5,218 (see "Investment Guide for Southeast Europe," www.seeurope.net).

[25] See "Bulgaria: Selected Issues and Statistical Appendix", IMF, March 2001.

[26] Annual wages were 3,156 leva (nearly $1,500) in the public sector and 2,556 leva (about $1,200) in the private sector. Figures cited from the National Statistics Institute. See "Early Warning Report," UNDP, March 2001.

[27] In GNP per capita terms, incomes declined about 50 percent from 1990 to 1996.

[28] Throughout the first half of the 1990s, real GDP was deeply negative. Only in 1994-95 was real growth positive, and this was only at about two percent each year after a steep drop from 1990-93.

[29] See Fischer, Stanley and Ratna Sahay, "Taking Stock", *Finance & Development*, September 2000.

[30] Most countries experienced the nadir of their output in 1995 or earlier. Exceptions are Kazakhstan (1998), Moldova (1999), Russia (1998), Tajikistan (1996), Turkmenistan (1997) and Ukraine (1999).

- **Overall unemployment was about 18 percent at end 2000**. The total number of registered unemployed was 682,800 at end 2000, higher than any year-end figure at least since 1993[31]. With registered unemployed approaching 700,000 and a total labor force of 3.3 million, the ratio is actually higher at about 21 percent. Only about 200,000 people were receiving unemployment benefits as of end 2000. Reforms in 2000 included submission of draft amendments to the Labor Code to allow for more flexible hiring/firing practices, adopted in March 2001.

- **It is still difficult to measure productive employment**. While a tightening of budget constraints on and reduced lending to inefficient and commercially non-viable enterprises has triggered some of the rise in unemployment, the informal sector remains large. Many enterprises at least partly rely on barter and arrears. It is not uncommon for people to work without contract so that firms can continue to operate without paying what are viewed as onerous personnel-related benefits. Thus, at a minimum, wages are often under-stated by firms to reduce their official tax obligations, while part of workers' total compensation is paid in cash or goods to offset some of the reduced benefits paid by companies. Thus, neither unemployment rates nor underemployment rates are considered accurate.

- **Recent GDP growth has been characterized by an 80 percent increase in fixed investment (from domestic and foreign sources) since 1997, amounting to 16 percent of GDP in 2000**. However, labor productivity still lags other EU accession countries (although there may be some problems with the data[32]), and this has stifled growth in its exports. While labor productivity is up in the Bulgarian manufacturing sector (except for textiles) as compared with 1993 measures, it has not had the sizeable increases shown in Hungary, Poland, the Czech Republic, and Estonia. On the other hand, its performance in this regard has been slightly behind that of Slovenia and the Slovak Republic, comparable to Romania, and ahead of Lithuania and Latvia.

- **Year-on-year CPI rates have shown extraordinary declines since 1998, representing one of the major successes achieved by the previous government**. At end 1997, CPI rates were 549 percent. Moreover, Bulgaria experienced four-digit inflation rates for seven consecutive months in 1997, triggering emergency action to establish the currency board arrangement (CBA). The effectiveness of the CBA was indicated with year-end 1998 CPI of only 1.7 percent. While year-end 2000 inflation rates were 11.4 percent, higher than projected 6.0 percent and higher than 7.0 percent at year-end 1999, this was largely due to higher energy prices. Drought also affected agricultural output, driving up prices for food products. Overall, the central bank and government have been successful in achieving price stabilization. Expectations for 2001 are that year-end CPI will approximate 4.5 percent.

- **The government maintained fiscal discipline for the third continuous year, with**

[31] In 1993, the number of registered unemployed was 626,100 at year end, equivalent to a 16.4 percent official unemployment rate (and 16.4 percent of the total labor force).

[32] For instance, 1999 labor productivity in services was considered less than 1993 levels. Part of the problem may be that statistics do not cover companies with five or fewer employees. Many of these very small firms are likely to provide significant services to the economy. Moreover, there are likely to be more of these kinds of firms in 1999-2000 than there were in 1993 or earlier.

deficits amounting to only 1 percent of GDP. In addition, revenue increased sufficiently for the previous government to introduce further tax rate reductions. This represents a dramatic change from fiscal management through 1996, when fiscal collections were only about 20-25 percent of GDP and deficits were financed through arrears and unsustainable levels of domestic borrowing[33]. Non-interest expenditure has continued to increase, which has translated into increased social security and social assistance payments, increased investment in infrastructure, and ongoing maintenance and repair of many public works. Key reforms in 2000 included creation of a Unified Revenue Agency, establishment of the Single Treasury Account at BNB to consolidate government accounts, preliminary pension reform to meet rising costs, and health care reforms for improved cost recovery and outpatient care.

- **Exchange rates depreciated against the US dollar, as was the case for the Euro and all other major traded currencies**. By end 2000, the leva traded at 2.10 to the US dollar, as compared with 1.95 at end 1999. This had an adverse effect on Bulgaria's balance of payments, as dollar-denominated energy prices drove up the current account deficit to 5.7 percent of GDP and added to the costs of production of most industry that, in Bulgaria, remains highly energy-dependent and -inefficient. Overall imports increased by 20 percent, much of it related to higher prices. Volume only accounted for about a 4 percent increase in total imports[34].

- **The balance of payments experienced a slight deterioration in 2000 as a result of exchange rate depreciation**. Nonetheless, there were some very positive trends. First, exports increased by 22 percent, reflecting improvements in some sectors' productivity and competitiveness—clothing and footwear, and petroleum products. Second, Bulgaria experienced another increase in FDI, attracting nearly $1 billion in 2000 as compared with $789 million in 1999 and an average $522 million in 1997-98. In general, Bulgaria had no problem financing its current account deficit or debt service requirements. Official reserves approximated $3.5 billion at end 2000, or about six months of import cover[35]. External debt at end 2000 was about 86 percent of GDP. Debt service due from 2001-2005 is projected to be $6.8 billion in total, of which nearly $1.6 billion is due in 2001. Bulgaria is expected to manage such payments without significant problems.

---

33 Fiscal deficits were fairly deep throughout most of the 1990s until 1997. This was largely due to the run-up of tax arrears, rather than direct budgetary subsidies (although "transfers" represented 11-14 percent of GDP in 1995-96 on a declining basis). Deficits as a percent of GDP reached as high as 13.4 percent in 1996. The reduction of the deficit to 3.2 percent in 1997 mainly reflects better controls on expenditure. There was some marginal improvement in collection, mainly from broader coverage through the collection of VAT and other indirect taxes. Revenues as a percentage of 1997 GDP were 23 percent, compared with 21 percent in 1996 and 23 percent in 1995.

34 See "Bulgaria 2001," Merrill Lynch, March 6, 2001.

35 2000 imports totaled $6.5 million, or $541 million per month. $3.5 billion/$541 million = 6.5 months.

Table 1. General Economic Indicators							
	1992	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Real GDP Growth	-7.3%	2.1%	-10.9%	-6.9%	3.5%	2.5%	5.6%
GDP Per Capita (US$)	1,014	1,563	1,179	1,230	1,490	1,513	1,470
Official Unemployment		11.1%	12.5%	13.7%	12.2%	16.0%	18.0%
Inflation Rate-y-o-y CPI	79.2%	32.9%	310.8%	578.5%	1.0%	6.2%	11.4%
Lev:$ Exchange Rate (y-e)	24.50	70.70	0.49	1.78	1.68	1.95	2.10
Fiscal Deficit/GDP	-5.2%	-5.6%	-10.4%	-2.1%	0.9%	-0.9%	0.4%
External Debt/GDP	160.4%	77.4%	96.8%	95.9%	81.8%	79.7%	86.0%
Debt Service/Current Account	8.6%	13.5%	16.8%	13.8%	19.0%	16.9%	<20%

Sources: BNB; IMF; EBRD

Table 2. Economic Structure and Private Sector Indicators							
	1992	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
GDP ($mn)	**8,204**	**13,105**	**9,831**	**10,146**	**12,255**	**12,404**	**12,057**
o/w Agriculture	12.0%	13.4%	15.3%	26.6%	21.1%	17.3%	15.2%
o/w Industry	40.5%	32.7%	30.2%	28.2%	28.7%	26.8%	28.6%
o/w Services	47.5%	53.9%	54.5%	45.2%	50.2%	55.9%	56.2%
Private Sector GDP ($mn)	**2,051**	**6,553**	**5,407**	**6,088**	**7,966**	**8,683**	**9,043**
o/w Agriculture	59.0%	81.8%	97.6%	98.6%	99.4%	99.3%	99.6%
o/w Industry	10.7%	27.7%	24.9%	34.4%	44.2%	53.3%	68.0%
o/w Services	32.2%	57.1%	61.4%	60.6%	60.5%	61.1%	61.4%
State Sector GDP ($mn)	**6,153**	**6,553**	**4,424**	**4,058**	**4,289**	**3,721**	**3,014**
o/w Agriculture	41.0%	18.2%	2.4%	1.4%	0.6%	0.7%	0.4%
o/w Industry	89.3%	72.3%	75.1%	65.6%	55.8%	46.7%	32.0%
o/w Services	67.8%	42.9%	38.6%	39.4%	39.5%	38.9%	38.6%
Employment ('000)		**3,032**	**3,085**	**3,030**	**2,921**	**2,811**	**2,736**
o/w Private Sector		28.8%	32.7%	38.2%	43.6%	48.2%	52.8%

Notes: Private sector share of 2000 GDP assumed to be 75 percent; sector GDP for 2000 are preliminary.
Sources: IMF; EBRD; National Statistical Institute

2.2. Economic Structure and Private Sector Development

Bulgaria is on an irreversible course of private sector growth, with particular strength in services and growing strength in the industrial sector. Virtually all sectors of the economy are now driven by private sector companies with the exception of the water, gas and electricity sector, telecommunications (where there is private competition from two GSM operators), and a handful of other companies that are either minor to the economy (e.g., mining) or to be privatized in the next few years (e.g., tobacco, tourism). **Since 1997, private sector output has increased from $6.1 billion (1997) to an estimated $9.1 billion (2000). This has been accompanied by increasing productivity, and more recently, a sizable increase in export volume**.

The structure of the economy has broadly shifted in the last four years. At end 1997, agriculture accounted for 27 percent of output, as compared with 15 percent in 2000. The shift in composition has generally been visible in services, which now accounts for 56 percent of GDP. Industrial share has settled at about 28 percent of GDP since 1997.

In terms of employment, the state remains a major employer, accounting for 47 percent of the total officially employed work force. While government employees and employees of state-owned enterprises are comparatively well paid, the statistics may be off. Private sector compensation is generally less than public sector employment, but it is commonly acknowledged that private sector rates are deflated by employers to avoid/reduce tax obligations. Some of the foregone tax payments from employers are paid in cash off the books to employees.

As for firms and firm size, Bulgaria had about 200,000 or so registered enterprises. It is uncertain how many are operating at commercially viable levels. While the total number of registered firms is about 210,000, another source reported only about 70,000 firms with more than five employees. **It is possible that nearly two thirds of registered firms are operating at sufficiently low levels of utilization to be considered non-viable.** In general, firms are small-scale in Bulgaria.

Government recognizes the need to improve the business environment, and has recently taken measures to make conditions more conducive to the private sector. A significant number of licensing and registration requirements have been streamlined. Direct tax rates on corporate profits, personal income, and personnel benefits (e.g., social insurance) are coming down in a bid to increase compliance. Recently introduced pension reform is meant to shift some of the burden away from employers to employees. Meanwhile, depreciation schedules are being revised to stimulate greater investment in high technology ventures and to stimulate increased re-tooling of manufacturing (including agro-processing). Faster VAT refunds are intended to serve as a catalyst for leasing and other activities that require major up-front investment. The new government also has proposed reducing personal income tax rates and raising thresholds, and eliminating taxes on capital gains from securities transactions, on interest income, and on retained earnings. For banks, the new government has also proposed eliminating taxes on loan loss provisions.

There is still skepticism among many that government reforms and initiatives have not done enough to rein in corruption, to streamline the tax burden, and to move forward with greater transparency in privatization transactions and securities market development. Nonetheless, many of the fundamentals appear favorable, as shown in increasing levels of investment, productivity and export volume. Should real GDP continue to increase at 5-6 percent, as in 2000 and as forecasted, this should help in bringing down the official unemployment rate, making the fiscal base more viable, and increasing Bulgaria’s prospects for competitiveness and sustainable growth. **Score: 3**

- **The structure of the economy has shown growth in services, and recent growth in**

industry, while agriculture has weakened. There has also been a salient shift to increasing private sector ownership in most sectors, with the state retaining prominence only in electricity, gas and water supply and telecommunications. There are still some key banks that remain in state hands along with large companies in the tobacco, telecommunications, and energy sectors. However, the previous government expected that these would be privatized over the next few years, and that the state's share of the economy would then likely be less than 20 percent. Net losses in the state sector approximated 2.2 percent of 1999 GDP, or about $250 million, providing a financial incentive for continued privatization and divestiture.

- **Agriculture has experienced stagnation and decline in recent years, with a 15.5 percent decline in output in 2000** (based on market prices) due to drought. In addition, the previous trend towards a reallocation of labor back to the primary sector from the industrial sector has stopped in recent years as investment in manufacturing has increased. Consequently, agriculture's share of overall GDP has declined steadily over the years, from a high 26.6 percent in 1997 to only 15.2 percent in 2000. This translates into overall output declines from $2.7 billion in 1997 to $1.8 billion in 2000.

- **In terms of ownership, agriculture has been and remains primarily private sector-oriented**. In terms of total output and gross value added, private sector share was nearly 100 percent. In 2000, this amounted to about 15 percent of GDP, or about $1.8 billion. This is in contrast with 1997 results, which showed private agriculture to be about 26 percent of GDP, or $2.7 billion. The state link to agriculture is primarily via Bulgartabac, the tobacco monopoly. However, state farms and other remnants of central planning have largely vanished.

- **The industrial sector reported strong growth in 2000 at 12 percent after suffering a decline of 4.4 percent in 1999**. Growth in 2000 came largely from the private manufacturing sector (e.g., clothing and footwear, petroleum products), as well as a slight increase in some of the public utilities (e.g., electricity, gas, water). Overall, industrial output in 2000 approximated $3.4 billion, or 28.6 percent of total GDP. This compares with $2.9 billion in 1997, approximately the same share of GDP.

- **Industrial sector ownership is increasingly private, accounting for 68 percent of total industry as of end 2000**. The private sector dominates in manufacturing and construction, with their pro-rated shares amounting to about 20 percent of overall 2000 GDP[36]. Public ownership is still nearly complete in electricity, gas and water supply, and the state still controls about two thirds of the relatively insignificant mining sector. All together, the state industrial contribution to GDP was about 5 percent. These proportional shares are in stark contrast to a few years ago, when the state accounted for most industry. For instance, in 1996, the state share of industry was 75 percent. The greatest change has occurred in manufacturing, where the private sector has shown high growth rates of 21-61 percent year-on-year since 1997. In contrast, the state has shown declines of 8-53 percent year-on-year during the same period. In general, apart from electricity, gas and water,

[36] Private sector share of manufacturing was 86.6% in 2000, and manufacturing was 18.1% of gross value added. Thus, 86.6% x 18.1% = 15.7%. In construction, the private sector share was 83.0%, and construction was 3.8% of gross value added. Thus, 83.0% x 3.8% = 3.2%. Residual private sector shares in mining and quarrying would bring this to 20 percent of total GDP.

state industry has declined since 1997 while the private sector has generally shown high growth rates.

- **One of the major problems facing Bulgarian industry is its dependence on energy resources for the industrial sector**. While this dependence has diminished in recent years, Bulgaria still remains far more energy-intensive in its consumption as a percentage of GDP—about 20 percent in 1999, as compared with less than 15 percent for all the other nine transition countries negotiating entry with the EU[37]. While it produces more energy than all the other transition accession countries (or about the same as Poland and Romania as a share of GDP), this leaves a substantial energy deficit of about 10 percent of GDP, or more than $1 billion in 2000. This shows up in the balance of payments figures, as energy imports were 27 percent of total imports. This is also the main reason why Bulgaria has a large trade deficit with Russia, the latter of which accounted for about 24 percent of Bulgaria's imports in 2000[38].

- **Services output has increased steadily throughout the last several years**. This sector accounted for about 56 percent of total GDP in 2000, or about $6.7 billion. By contrast, services were only $4.6 billion in output in 1997. The increase has come a number of sectors, including trade, motor vehicle repair, household appliances, transport and communications, and financial services, much of this reflecting an increase in consumer spending and retail trade. Employment in services was about 45 percent of total in 1999, up from 35 percent in 1989.

- **Both the private sector and the state remain important, with the private sector playing an increasingly prominent role in the provision of services to the marketplace**. As elsewhere among transition countries, services have shown major growth for many years. This partly reflects underdevelopment during the central planning era, and rising incomes and pent-up demand during the transition period. As of 2000, the <u>private sector</u> accounted for about 61 percent of services, about the same as in 1997, but up from 45 percent in 1993-94. This amounted to about $4.1 billion in 2000, or 34.5 percent of total GDP, as compared with $2.8 billion in 1997. The private sector accounted for 90 percent of trade, 64 percent of transport, 40 percent of communications, and nearly 60 percent of all other services, including major shares of banking and tourism. Since 1998, private sector services have shown year-on-year growth of 4-13 percent, with 2000 being the year of highest growth. Meanwhile, <u>the state</u> remains prominent in services by virtue of normal functions of public administration, and ownership of the major fixed-line telecommunications firm. BTC, the state-owned telecommunications operator, should be at least partly privatized by 2003-04[39]. Likewise, the previous government was moving on with pension and health care reform that should lead to increasing provision of private services, and the new government is expected to continue along these lines. Nonetheless, as of 2000, the state share of services was 39 percent, equivalent to 22 percent of GDP, or about $2.6 billion. Performance has been mixed, depending on sub-sector. State transport

---

37 On this note, Estonia, Hungary and Slovenia had energy consumption statistics as low as about 10 percent of GDP.

38 Bulgaria only exported 2.5 percent of total to Russia, leaving a trade deficit of about $1.5 billion with Russia for 2000. In 2000, imports increased substantially from Russia while exports decreased.

39 This was confirmed in comments made by the head of Bulgaria's Privatization Agency at the annual EBRD meetings. See *The Sofia Echo*, April 27-May 3, 2001, p.5.

companies have shown steady declines since 1997, and state trading companies have experienced year-on-year declines since the early 1990s. However, state enterprises in communications and other services have shown increases since 1999.

- **The number of registered firms is relatively small**. One source indicated there are 69,000 private sector companies and about 1,500 state enterprises that employ five or more people[40]. However, other figures indicate there were about 210,000 enterprises registered at end 1999 that employed 10 or more people[41], although some of these may be inactive. Beyond this, there are thousands of other companies and self-employed operators that are not covered in national statistics. Estimates of the "informal" economy are often in the 40 percent of GDP range, some of which is presumably captured in PPP estimates of per capita incomes. This compares with lower estimates in earlier years. The share of the unofficial economy in GDP figures was estimated to be 36 percent in 1995, rising steadily from 23 percent in 1989[42]. One study based on enterprise surveys shows the estimate for the informal sector peaked at 34 percent in 1996 and has declined since, with about one third of total taxes evaded, about the same level as labor costs evaded in the form of compensation benefits (e.g., social security) that are officially mandated[43].

- **About 70 percent of Bulgaria's GDP is now generated by the private sector**[44]. This is generally high by transition country standards, and consistent with the government's position to move away from state ownership in the economy. For instance, based on EBRD estimates, only three other EU candidate transition countries had 70 percent or more of their GDP produced by the private sector. However, governance, fraud and corruption remain serious problems, and this has served as a deterrent to investment and lending.

- **Private sector employment levels have lagged the private sector contribution to GDP**. As of 2000, 53 percent of total employment[45] originated from private firms, less than the 70 percent contribution to GDP. However, this is not uncommon, as private firms tend to be more efficient. Rather, such statistics are more a reflection of the heavy personnel load of the public sector in relation to GDP contribution. As of 2000, the state sector had 1.3 million registered employees, 47 percent of employment, while contributing less than a third to GDP.

- **As of end 2000, privatization had involved 9,248 privatization transactions involving whole companies, or parts of companies, at both the state and municipal levels**. In the case of municipal level transactions, these were largely concluded in 1998 and involved 4,830 transactions. At the state level, 4,418 transactions have been carried out involving

---

40 See "Bulgaria: 2000 Article IV Consultation", IMF, March 2001.

41 These data are cited by the Agency for Small and Medium-sized Enterprises, and are based on figures from the National Statistical Institute.

42 See EBRD *Transition Report*, 1997.

43 See "The Shadow Economy in Bulgaria", Harvard University, the Agency for Economic Analysis and Forecasting, and the Institute for Market Economics, Sofia, October 2000.

44 The IMF cites NSI figures of 68.9 percent private sector share of gross value added at basic prices as of 3Q 2000. By comparison, these figures were 63 percent in 1997 and about 50 percent in 1995-96.

45 This was equivalent to 44 percent of the total labor force. The balance is either employed by the state (and other unknown sources), or unemployed.

more than 3,500 companies. The Privatization Agency has handled the largest enterprises, while ministries and committees handled smaller or less complex transactions, and the Center for Mass Privatization handled the mass privatization voucher program in 1997. Privatization activity in the state sector has accelerated since 1997, with 2,776 transactions carried out from 1998-2000. All together as of end 2000, Bulgaria had privatized more than half of long-term assets, roughly estimated to account for $1.4 billion in privatization receipts to the budget and a total of $3.7 billion in overall privatization proceeds.

- **Since end 1996, Bulgaria has seen the number of state enterprises decline from 5,492 to 2,274 at the end of 1999 and about 1,500[46] at the end of 2000**. Some of this has been from failure, although most have involved sales or transfer transactions in one form or another. More than half of state assets have been sold in the last few years. Strategic sales via auction and tender have included large enterprises, as well as most of the Group I and II banks.

- **The state enterprise sector is now less of a financial burden than before, although it remains a burden**. Improvements in financial status have been partly due to the previous government's efforts to contain public sector wages since 1997, to encourage privatization and restructuring, and to reduce arrears owed to banks due to the enforcement of stricter prudential norms. Nonetheless, the SOE sector posted net losses of about $250 million in 1999, or 2.2 percent of GDP. In particular, the 100 largest loss-making SOEs in the isolation program have shown steady and growing losses, rising from 684 million leva in 1998 to losses of nearly 1.4 billion leva in 1999. Moreover, recognition by banks of loss loans amounted to a cost to banks, which has also added to their current reluctance to lend and assume risk. Among the 2,274 SOEs at end 1999, only 600 were considered able to meet all costs. About one third were considered unable to generate sufficient revenues that covered anything but material input costs. Another one third could only generate sufficient revenues to cover material inputs and wages, but not other expenditure or depreciation. Thus, at least two thirds of SOEs would be unable to mobilize sufficient earnings or financing for needed reinvestment. At end 1999, SOEs had more than 7 billion leva in debt, of which 1.9 billion leva was owed to banks. At end 1999, arrears on bank loans from state enterprises were reported to be 221 million leva, or 11.5 percent of bank credit. However, SOEs also had an additional 1.3 billion leva outstanding to "other" creditors, a combination of payments made in advance by customers as well as interest accrued but not paid to banks. Thus, the risk associated with SOEs for bank exposure has been high and partly explains bank reluctance to lend to most state and many privatized enterprises. Other SOE liabilities included 1.6 billion leva to suppliers, nearly 1 billion leva to government in taxes, and 200 million leva to employees.

- **Head count in the state sector remains high, notwithstanding layoffs that have added to the high 18 percent official unemployment rate**. Total public sector employment was 1.3 million, or 39 percent of the total labor force and 47 percent of total employment. Among the net increase of 217,600 registered unemployed since end 1998, most are thought to have been released from privatized enterprises or from state enterprises unable to carry the costs of personnel. In fact, the net reduction of public sector employment from

[46] Figure from end 2000 cited from IMF. See "Bulgaria: 2000 Article IV Consultation", IMF, March 2001.

1998-2000 was 364,400, suggesting that private sector employment has absorbed some of those released. Private sector employment increased by 172,200 from 1998-2000, offsetting some of the impact of state sector layoffs.

- **The previous Government announced its plans to privatize some large-scale enterprises, yet the timing and transparency of transactions is frequently challenged, and delays could weaken the country's balance of payments**. There are plans to privatize the fixed-line telecommunications operator (BTC) in 2003-04, after its monopoly status lapses (which should reduce proceeds generated). Other companies slated for privatization at some juncture are Bulgartabak (tobacco), Balkancar (tourism and transportation), and several energy companies. However, all of these are subject to political sensitivity and pricing policies that may delay transactions from proceeding any time soon. This position may be justified in some cases, such as currently in the weak telecommunications sector where previously large investors are exiting earlier investments to reduce debt[47]. However, in other cases, delays and conditions surrounding privatization may reflect political considerations that are domestic, but could stifle investment flows (e.g., tobacco). With the risk of official and bilateral financial flows diminishing due to other country needs (e.g., Yugoslavia), this could potentially lead to a deterioration in the balance of payments unless compensated by other sources. This would generally point to FDI, which might be less as a result of privatization delays. However, this is not automatic. To date, much FDI has actually gone into greenfield operations rather than privatized firms.

- **The business environment is inadequate and has stifled private sector competitiveness**. These obstacles have also provided creditors with fewer incentives to make loans or to invest. Key weaknesses include administrative obstacles (e.g., licensing, permits), inadequate enforcement of laws and regulations, bribery and corruption, and inefficient delivery of government services. The previous government was making efforts to improve the situation, such as streamlining administrative requirements by simplifying business registration procedures, training commercial judges, introducing improvements in public administration compensation, and lowering tax rates to increase compliance. For foreign investors with majority stakes in business concerns, Bulgaria was drafting a law to permit international arbitration for dispute resolution. To date, Bulgaria lags most of the accession transition countries in general enterprise reform efforts, although it appears to be equal with Romania and ahead of Lithuania and Slovenia[48]. These countries have all been relatively slow to privatize and/or remove barriers to private sector growth. The new government is planning to improve the business environment to make it more conducive to investment.

- **Foreign investment trends show that Bulgaria has not kept up with the more advanced transition countries in attracting EU investors into the real sector, although Bulgaria has succeeded recently in the banking sector**. In the industrial and services sectors, a substantial portion of foreign investment has come from neighboring non-EU countries that have established new operations in Bulgaria, rather than investing directly

[47] Two examples as of May 2001 are British Telecom, which is reducing debt, and KPN, the Dutch telecommunications firm that originally teamed with OTE (Greece) for Bulgaria's second GSM license, and is now seeking to sell its stake in SPT, the Czech telecom firm in which it invested several years back.
[48] See EBRD *Transition Report*, 2000.

into privatized enterprises. Most FDI in manufacturing is reportedly concentrated in resource and labor-intensive (e.g., textiles) sectors, and not in knowledge-based or major capital-based applications. However, the situation in banking is different. Bank privatizations have accounted for about $800 million in FDI since 1992. Most recently, Bulgaria's largest bank, Bulbank, was sold to Unicredito (Italy) for about $330 million-equivalent for a 93 percent share. Earlier in 2000, the National Bank of Greece acquired 90 percent of Universal Bank of Bulgaria for $207 million. Bulgaria's comparatively high FDI since 1998 has been partly the result of major privatizations, with these two banks alone accounting for about $500 million in FDI in 2000. Other bank privatizations brought in less. FDI in all financial services at end 1999 had accounted for about 12 percent of cumulative FDI from 1992-99, or about $330 million. The two big bank privatizations raised the share of financial services to total cumulative FDI to about one third.

- **Governance is problematic for a number of reasons, one of which is the method of privatization pursued by the previous government**. These approaches have been criticized in Bulgaria and elsewhere for failing to contribute to strong governance, not adding needed financial capital, permitting earlier and unreformed management teams to continue running enterprises based on unsound practices, and in many cases permitting asset stripping. While small enterprises do not need to be drawn out or complex, the aforementioned approaches have generally been considered counter-productive for medium and large firms. In the case of mass privatization, investment funds have been unable to play an effective institutional investor role in corporate governance because they have found it difficult to remove unqualified or inefficient managers who draw support for their employees, municipal officials and others with a stake in the enterprise. As discussed in sections 3 and 4, problems in the real sector make it risky and often imprudent for banks to lend. These problems apply to both minority and majority shareholders due to shrinking quorums, management capacity to manipulate and delay the scheduling of shareholder meetings, and management ability to conceal insider transactions that can dilute shareholder value and deplete cash resources through contracting.

2.3. Money, Savings and Credit

Conditions have broadly improved in terms of monetary policy and management in recent years. The CBA has induced financial discipline, which has translated into relatively stable inflation rates (despite a rise in 2000 due to dollar-denominated pricing of key import commodities, and a general depreciation of the Euro to the dollar) since 1997-98. This compares with the collapse of the Bulgarian economy in 1996-early 1997, during which bank deposits declined from $7.4 billion at the end of 1995 to $1.8 billion at the end of March 1997. While there are still some risks, mainly related to exchange rate and maturity mismatches that could have a marginally destabilizing effect on the economy (e.g., a sharp drop in the Euro would add stress to the debt profile and exacerbate the current account deficit), monetary management has been broadly viewed as stable and contributing to sustainable real growth.

While broad money levels are still below aggregates achieved in 1992-96, there has been an increase since 1997 of about $700 million, or about 20 percent in dollar terms. Deposits held with banks have likewise increased $415 million (net) since 1997. Under the current circumstances in which banks are paying negative real interest rates on deposits, it is actually a significant accomplishment that funds have been mobilized. In fact, the paucity of investment opportunities for banks has served as a disincentive to deposit mobilization efforts until recently, as their assets have been largely placed in low-risk, low-return investments. Banks' movement towards expanding retail/consumer banking operations in Bulgaria reflects a turning point from stabilization to growth. This is expected to alter deposit-related features and pricing as banks increasingly seek to build franchise value. Along with other developments (including tax rate reduction for businesses and households), it is expected that deposits with banks will increase, and that banks may increase rates paid on medium- and long-term instruments to provide greater stability to their funding bases.

In the banking sector, the CBA significantly curtails the abuse of refinancing and lender of last resort embedded in monetary policy and credit practices through the end of 1996. This has translated into low levels of lending, which currently stand at about 12-13 percent of GDP. However, the last three-four years have had a cleansing effect on portfolios, and **most banks now generally have significant capacity to lend relative to capital levels**. This is particularly true of the Group I-III banks, which are the largest banks. Branches of foreign banks (Group V) likewise can access additional funding as needed. Thus, while there have been critics of the stabilizing developments of the last few years, banks now appear poised to increase their lending and risk assumption. Part of the reason is due to the stable monetary environment created by the CBA, which has also contributed to foreign investment into the banking sector. **Score: 3+**

- **Broad money has increased in dollar terms from $3.4 billion in 1997 to $4.1 billion at end 2000**. While still below figures recorded from 1991-95 when broad money ranged from $4.6-$8.3 billion, it is known that broad money alone is not a reliable indicator of sustainable intermediation trends or stable monetary policy (in Bulgaria or elsewhere). To the contrary, Bulgaria's economic and financial crisis was building up during the mid-1990s, even when broad money figures were comparatively high and growing[49]. Thus, government has made efforts since the crisis and subsequent introduction of the CBA to put monetary and financial management on a sound basis. The new government plans to maintain the CBA.

- **Bulgaria's broad money figures reflect a favorable trend, although these figures are still lower than most of the EU candidate countries**. Based on 1999 figures from EBRD, Bulgaria's broad money figures were higher than those of Latvia, Lithuania and Romania, but lagged all others. With most of the other accession countries in the range of 43-53 percent of broad money to GDP[50], this suggests that Bulgaria should be able to hit a target of 45-50 percent in the next few years if it is to compete with its regional peers.

- **Rising levels of broad money could significantly increase funding for banks (as well as for capital markets, pension funds, and life insurance investments)**. With the IMF and government projecting real GDP growth of about 5-5.5 percent for the next six years, this would translate into an additional $1 billion into the banking system even without a proportional increase in broad money held with banks[51]. If broad money were to reach 45

[49] Year end 1995 per capita broad money figures were about $1,000, higher than [most] transition economies.

[50] Estonia (42.7 percent), Hungary (46.2 percent), Poland (43.1 percent) and Slovenia (52.6 percent) represent the middle range, and the Czech (75.4 percent) and Slovak (64.6 percent) Republics are at the top of the 10 transition candidate countries.

[51] With real GDP growth of 5% from 2001-2003 and 5.5% from 2004-2006, GDP would be $16.3 billion by 2006. Holding broad money at 34 percent of GDP (as in 2000), this equals $5.5 billion, as

percent of projected GDP (as in many peer countries) and the same 75 percent remained with the banks in the form of deposits, this would translate into a net increase in deposits for the banks of $2 billion[52]. While not all incremental savings would be expected to be placed with banks, the introduction of expanded contractual savings options is expected to increase aggregate savings, and this should be beneficial to bank deposit mobilization as well.

- **There is a major mismatch in Euro-denominated assets at the BNB and dollar-denominated external debt**. BNB assets were 85 percent Euro-denominated in March 2001 while external debt obligations were about 65 percent dollar-denominated. This clearly presents exchange rate risk, particularly given the longstanding strength of the dollar against the Euro. There are also reported to be issues regarding the smoothing out of payment flows, and the narrowing of gaps in interest rate features (variable vs. fixed). However, none of these is reported to be so serious as to jeopardize Bulgaria's ability to meet its international obligations. Rather, they point to efficiency issues with regard to debt structure, internal accounting, and related issues.

- **The 31 percent increase in broad money roughly correlates with a general increase in deposit mobilization at about 25 percent above end 1997 levels (adjusted on a dollar-denominated basis)**. Banks have received an incremental $415 million in household and enterprise deposits since end 1997, although the total system (including BNB) has shown an overall increase in deposits (leva and foreign currency) of nearly $1.4 billion. The relatively low increase in the banks may reflect the need for cash holdings in the enterprise and household sectors, as well as some residual public concern about the underlying safety of deposits in some banks. The latter risk has been partly offset by confidence in the CBA, high levels of capital in the banking system, and establishment of the DIF. While it is unclear how much funding is kept outside the banking system due to problems associated with confidence, cash held outside the banks is thought to be more related to lack of household and enterprise cash surpluses, the need for cash to affect transactions, and concealment of income to avoid tax payments. Annual per capita incomes are only about $1,500 on a GNP per capita basis, thus financial resources are not widely available to or from the banks. Moreover, while most banks are stronger than they were in 1997, there are still several banks[53] that are carrying high levels of loss loans and are small in terms of capital. In light of continued weaknesses in some banks and the failure of others in recent years, the public may be holding back on deposits. The relatively low level of incremental resource inflows into the banks may also reflect the relatively low interest rates paid on deposits. In other markets, depositors have shown themselves to be price-sensitive. However, as the banks are already highly liquid and moderately profitable, they have no particular reason to raise interest rates paid on deposits. At end 2000, banks' deposit

opposed to $4.1 billion at end 2000. If the same 75% was still held with the banks (as in 2000), this approximates $1 billion. (M0 was 25.5 percent of total money at end 2000. M1 totaled 39.1 percent, M2 was 55.7 percent, and foreign currency deposits were 44.3 percent.)

[52] 45% x $16.3 billion =$7.3 billion. 75% x $7.3 billion = $5.5 billion (possible 2006 deposit level). This compares with $3.4 billion at end 2000.

[53] These are the Group IV category of banks in BNB statistics.

distribution[54] was 22 percent in demand deposits, 24 percent in time and saving deposits, and 54 percent in foreign currency deposits.

- **Basic trends in 2000 showed slight movement out of lev-denominated savings and time deposits into foreign currency accounts**. This is most likely the result of higher than anticipated inflation rates in 2000, with depositors moving their funds out of local currency accounts and into dollar-denominated accounts to hedge against rising inflation and Euro depreciation. In terms of overall broad money composition, foreign currency deposits were 44.3 percent of total at end 2000 as compared with a high 67.6 percent in March 1997, just before the CBA was introduced.

- **Credit figures from monetary survey data show low levels of net domestic assets, but steady increases in credit flows to the private sector**. Net domestic assets were about 1.6 billion leva at end 2000, or $760 million. This is low, and amounts to only $92 per capita. On a percentage basis, two thirds of credit was in the form of foreign currency at end 2000[55]. In terms of recipient financing, 10.5 percent of net domestic credit went to government, 9.1 percent went to state enterprises, and 80.5 percent went to the private sector. This distribution compares with 43.5 percent to government, 25.3 percent to state enterprises, and only 31.2 percent to the private sector at the end of 1996. Thus, while overall credit figures are comparatively small in value, they are increasingly provided to the private sector. This also reflects legal restrictions on BNB with regard to lending to the state, which can only be done against the purchase of SDRs from the IMF.

- **Interest rates on loans are moderately positive in real terms, while rates paid on deposits are negative in real terms**. The latter has likely contributed to the relatively small deposit base of the banks, although general liquidity constraints at the household level likely are more important as an impediment to expanding the banking sector's funding base. At end 2000, annual rates on loans were 12.2 percent, nearly a percentage point above the year end CPI rate of 11.4 percent. However, this net spread is much less than previous year-end comparisons in 1998 and 1999, where annual loan rates were 11.8 percent and 5.4 percent, respectively[56]. As for rates paid on deposits, these have been fairly constant on a nominal basis since the currency board was introduced in July 1997. The annual range on time deposit rates since August 1997 has been 2.7-3.4 percent. At year end 2000, the rate was 3.3 percent, well below CPI and almost 9 percent less than annual interest rates on loans. Net spreads have generally been about 8-12 percent since mid-1997, and were 10.2 percent at end 1998 and 9.2 percent at end 1999.

- **Interest rates paid on deposits have not only been negative in real terms, but have fluctuated dramatically when compared to relatively stable dollar rates**. In real terms, rates paid on lev deposits have fluctuated fairly dramatically on a quarterly basis, and

---

[54] These figures are from BNB and do not include restricted deposits, deposits in non-operating banks, local or central government deposits, or deposits from state funds and extra-budgetary sources.

[55] These figures are based on gross lev and foreign exchange credit, and do not include other items net.

[56] Year end loan rates in 1998 (13.5 percent) less CPI (1.7 percent) = 11.8 percent. Year end loan rates in 1999 (12.4 percent) less CPI (7.0 percent) = 5.4 percent.

have usually been negative[57]. Annual uncovered interest differentials after factoring in exchange rate movements have pointed to dollar deposits providing higher returns than lev deposits three quarters a year since 1998[58].

- **Policy, design and implementation of monetary policy have been consistently driven by the requirements of the currency board operation since its introduction in 1997**. Under the Law on the Bulgarian National Bank, the central bank is responsible for administration of the currency board. This is effectively carried out through its "Issues Department", whose balance sheet contains the foreign currency assets needed to cover local currency emissions. The currency board was introduced to get monetary policy under control after several years of inflation, excess money growth, poor credit quality, and depletion of foreign currency reserves. These objectives have been achieved as the inflation rate has decreased significantly, money growth is under control, non-performing loans have been fully provisioned, and foreign exchange reserves have been restored. These goals were accomplished by end 1997, and stability has been sustained.

- **Data collection and forecasting appear adequate under the stable circumstances of the currency board**. There have been issues raised regarding the reliability and timelines of data, internal accounting standards, and the degree to which this undermines forecasting capacity. Part of this relates to ongoing questions with regard to the degree of money circulating outside of formal institutions. End 2000 data put the figure at about 24.5 percent. However, it is likely that hidden funds exist as well, likely from earnings not reported to tax authorities.

- **Bulgaria has taken regional and global considerations into account since the introduction of the currency board**. This represents a change from practices in the mid-1990s[59]. Only since the restructuring of Bulgaria's debt by official creditors with strong conditions attached has Bulgaria seriously attended to these obligations. The recent invitation to enter negotiations with the EU on accession should keep Bulgaria focused on monetary union. Current high levels of public confidence in the CBA suggest there is little likelihood this arrangement with change any time soon.

- **Management of monetary resources is tight and clearly defined under the currency board arrangement**. Under the currency board rules, there is limited scope for deviation from the pure foreign exchange (Euro) cover provided by the currency board operation. This includes well defined and highly conservative lender of last resort provisions in the event of a liquidity crisis at particular banks.

---

57 Since introduction of the currency board in July 1997, real time deposit rates were negative at quarter end 9 of 14 times through end 2000.

58 Figures from BNB and IMF staff estimates. See "Bulgaria: Selected Issues and Statistical Appendix", IMF, March 2001.

59 Prior to the collapse in 1996, Bulgaria was negligent with regard to its international obligations. This led to the steady depletion of foreign exchange reserves from mid-1995 that led to a near moratorium and prospective default on debt payments.

Table 3. Money, Savings and Credit Indicators							
(*millions of leva, %*)	**1992**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Broad Money/GDP	**79.1%**	**66.4%**	**74.9%**	**35.3%**	**30.6%**	**32.6%**	**33.7%**
Year-end Base Interest Rate	**49.7%**	**39.8%**	**435.0%**	**7.0%**	**5.2%**	**4.6%**	**4.7%**
Nominal Bank Rates							
short-term credit	64.6%	51.4%	480.8%	13.9%	13.5%	12.4%	12.2%
one-month time deposits	45.3%	25.3%	211.8%	3.0%	3.3%	3.2%	3.3%
Net Domestic Credit	**171**	**513**	**1,152**	**1,167**	**1,325**	**1,357**	**1,597**
o/w claims on Gov't	89	269	902	1,642	510	156	488
o/w claims on SOEs	135	169	525	1,254	946	713	422
o/w claims on Private	18	190	646	2,241	2,771	3,368	3,745
Net Domestic Credit/GDP	**85.1%**	**58.3%**	**65.9%**	**6.8%**	**6.1%**	**6.0%**	**6.2%**
o/w claims on Gov't	44.3%	30.6%	51.6%	9.6%	2.4%	0.7%	1.9%
o/w claims on SOEs	67.2%	19.2%	30.0%	7.4%	4.4%	3.2%	1.6%
o/w claims on Private	9.0%	21.6%	36.9%	13.1%	12.8%	15.0%	14.6%

Notes: Net domestic credit totals include other items net, which are not included in sector claims
Sources: BNB; Ministry of Finance

Table 4. Fiscal Indicators							
(*millions of leva*)	**1992**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Total Revenue	77	314	558	5,352	7,935	9,065	10,834
Non-Interest Expenditure	69	230	383	3,967	6,001	7,048	8,746
Total Expenditure	88	364	740	5,708	7,732	9,279	10,732
Primary Balance	2	75	162	999	1,154	683	1,185
Interest Expense	13	124	344	1,355	952	896	1,083
Budget Deficit	-11	-50	-183	-356	203	-213	102
Total Revenue/GDP	38.4%	35.7%	31.9%	36.8%	39.5%	40.5%	42.3%
Non-Interest Expenditure/GDP	34.4%	26.1%	21.9%	23.3%	27.8%	31.3%	34.2%
Total Expenditure/GDP	43.6%	41.3%	42.3%	33.5%	35.8%	41.2%	41.9%
Primary Balance/GDP	1.2%	8.5%	9.3%	5.9%	5.3%	3.0%	4.6%
Interest Expense/GDP	6.5%	14.1%	19.7%	7.9%	4.4%	4.0%	4.2%
Fiscal Deficit/GDP	-5.2%	-5.6%	-10.4%	-2.1%	0.9%	-0.9%	0.4%

Sources: Ministry of Finance

2.4. Fiscal

Fiscal developments have been broadly favorable since 1997. Policy has been consistently geared to reduced deficits. These were achieved as early as 1997, one year after the economic collapse. Since then, the average fiscal deficit has been less than 1 percent of GDP. Given fairly tight monetary conditions emanating from the currency board regime, this is an impressive accomplishment. As a sign of discipline, financing of the state enterprise sector has been reduced to virtually zero after major financing in the early/mid-1990s.

Meanwhile, the previous government made progress in a number of structural fiscal areas. **Revenues and expenditure have both increased since 1997**, with the fiscal accounts benefiting from a shift away from direct to indirect and consumption-oriented taxation. Rates continue to decline while collections continue to increase. The shift to increasing reliance on VAT and excise, 32 percent of fiscal revenue in 2000, has made it possible for rates to come down on corporate profit tax rates, personal income tax rates, and mandatory employer social security contributions.

Meanwhile, all of this has been accomplished despite dubious competitiveness resulting from privatization transactions, high levels of tax avoidance, and continued high stocks of external debt that are regularly serviced through the budget in six month intervals. **Continued growth in real GDP and international transactions, recent improvements in VAT refund provisions, and continued reductions in personal/corporate tax rates should continue to increase the fiscal base and revenues**. **Score: 3+**

- **Bulgaria has demonstrated a high level of fiscal discipline since 1997 after experiencing severe deficits through 1996**. Prior to 1997, the government relied on domestic debt[60] to finance deep deficits. Consequently, by 1996, the overall fiscal deficit was 10.4 percent of GDP, or $1 billion. This was about $125-equivalent per capita at the time when GNP per capita incomes were $1,200. Thus, over time, the accumulation of deficits became a major deferred liability for the average tax payer. From 1992-1996, the lowest deficit Bulgaria had was 5.2 percent (1992) of GDP, and the unweighted average for the five-year period was 7.6 percent of GDP. These practices changed in 1997, when the fiscal deficit declined to 2.1 percent of GDP. From 1998-2000, the overall balance has been moderately in surplus (1998, 2000) or slightly in deficit (less than 1 percent of GDP in 1999)[61].

- **As a function of fiscal discipline, the currency board arrangement has reduced the option for government to rely on high levels of domestic debt to finance budget deficits**. This has brought annual interest expense incurred by the budget to more manageable levels. After peaking at 17 percent of GDP in 1996, interest expense on domestic debt declined to 5.5 percent of GDP in 1997, and an average of 1 percent from 1998-2000. This has been partly supplemented with an increase in external borrowings, which have accounted for about three quarters of annual interest expense since 1998. Total interest expense incurred by the budget averaged 4.2 percent of GDP (unweighted basis) from 1998-2000, well below the average of 15.8 percent from 1994-96.

---

[60] Interest on domestic debt averaged 13.5 percent of GDP on an unweighted basis from 1994-96, peaking at 17 percent in 1996.

[61] Figures are all from the Bulgarian Ministry of Finance (cited in IMF). These differ from GFS definition figures, which show more positive fiscal positions from 1997-2000.

- **The previous Government demonstrated discipline with regard to arrears and subsidies, but this has also contributed to incentives for tax evasion**. While state enterprises and municipalities still have arrears, much of this is being cleared. Likewise, Bulgaria does not have the run-up of arrears on social security/pension, wage and related arrears that have plagued many other countries. While there are subsidies still extant in utilities pricing (mainly for household) and some directed lending to the agricultural sector, these are also coming down. Total subsidies were reported to be only 1 percent of GDP in 2000, down from 7 percent in 1996. However, the high level of non-payment in the tax system (notwithstanding recent improvements in performance) also attests to a high level of informal activity that has emerged as a result of tightened budget constraints.

- **With a more disciplined fiscal and debt management policy in place, neither the banking system nor BNB have been used as a substitute source of fiscal financing**. The BNB is not permitted to extend credit to the government unless it is against purchases of SDRs from the IMF, nor is it permitted to buy/sell government securities or securities issued by any other Bulgarian residents. Thus, monetary discipline has reinforced fiscal policy. While banks hold some government securities for portfolio purposes, these amounted to only net 328 million leva in 2000, a mere 3 percent of 2000 expenditure[62]. Meanwhile, BNB transfers were only 137 million leva in 2000, barely more than 1 percent of total fiscal revenues.

- **The previous government dramatically increased fiscal revenues from 1997**. On a local currency basis, revenues in 2000 were double 1997 collections. On a GDP basis, revenues have increased from 31.4 percent in 1997 to 42.3 percent in 2000. The increment has resulted mainly from increased collections from VAT and excise duties (a net increase of 5.2 percent of GDP since 1997), and from privatization proceeds[63]. The net increase in dollar terms (adjusted for exchange rates) approximates $2 billion[64], or about $244 per capita. Collection of tax revenues had been problematic for years, although improvements were registered in 1997. These improvements, combined with expenditure controls, contributed to declining interest rates in Treasury bill auctions resulting from the easing of cash needs for fiscal purposes. This trend has continued since, reversing earlier trends through 1996 that showed the run-up of tax arrears increasing from 4.7 percent of GDP in 1990 to 13.4 percent in 1996. These arrears resulted from non-payment on energy/electricity bills, and also were closely linked to the ongoing losses of the banking system that financed enterprises that might otherwise have received explicit budgetary subsidies prior to 1991. Efforts were stepped up in 1997 to collect on tax obligations from state enterprises, and to tighten up on customs operations. The latter effort has been helpful with revenue performance and collections.

---

[62] In fact, on a net basis, government paid banks 943 million leva in 1997-99, rather than the alternative that was in practice prior to the CBA.

[63] Non-tax revenues accounted for a net increase of 6.5 percent of GDP, of which a major portion has derived from privatization proceeds.

[64] 1997 GDP in US$ terms approximated $10.15 billion. Tax revenues that year were 31.4 percent of GDP, or $3.2 billion. 2000 GDP in US$ terms approximated $12.2 billion. Tax revenues were 42.3 percent of GDP, or $5.2 billion. With a population of 8.2 million, that translates into incremental per capita tax revenue of $244.

- **Because of the previous government's strong revenue performance and its desire to improve the business environment, the new government plans to continue to reduce statutory tax rates in 2001 and 2002, a process begun in 1999**. This is expected to include a further reduction in corporate profit tax rates by 5 points (to 20 percent in 2001 and 15 percent in 2002), social contribution rates by 3 points, and maximum personal income tax rates by 2 points (from 40 percent to 38 percent). Efforts are also planned to accelerate VAT refunds for non-exporters (from six to four months), simplify tax procedures, and permit accelerated depreciation of software products to stimulate knowledge-based investment and growth. The new government is also looking at the possibility of eliminating taxes on interest income, retained earnings, and capital gains from securities transactions.

- **While the previous government substantially increased fiscal revenues, it also dramatically increased public expenditure since 1997**. In 1997, fiscal expenditure was 33.5 percent of GDP, or about $3.4 billion. This compares with 41.9 percent of 2000 GDP, or $5.1 billion. Thus, government expenditure has risen considerably since 1997, particularly when taking into account the reduction in annual interest expense. Most of the increment has gone to social expenditure in the form of pension payments, and to a lesser extent, social assistance. In the case of the former, this has increased substantially from 6.3 percent of GDP in 1997 to 9.9 percent of 2000 GDP. In dollar terms (adjusted for exchange rates), this constitutes an increase of about $570 million in annual expenditure. These costs have been rising steadily since 1998, and have triggered movement towards introduction of a three-pillar pension scheme (anticipated for 2002). In the interim, the PAYG scheme was strengthened in early 2000 (e.g., rise in retirement age), and voluntary private pension funds were licensed. The latter held about 75 million leva in assets at September 30, 2000, and are now reported to have more than 100 million leva under management as of early 2001. Total pension fund assets could be as much as 500 million leva in the coming years[65]. Meanwhile, the increase in social assistance (from 1.6 percent of 1997 GDP to 2.1 percent of 2000 GDP) reflects rising unemployment. The government has also increased spending on maintenance and operations, public sector compensation, and capital expenditure.

- **Fiscal policy, design and implementation have been geared to bringing down fiscal deficits by reducing non-productive expenditure and improving collection levels since 1997**. Results have shown steady improvement in terms of reducing the fiscal deficit as a percent of GDP—2.1 percent in 1997 and less than 1 percent from 1998-2000, as compared to an average 9.1 percent in 1995-96. Most initial progress was from the expenditure side, where more stable policies were introduced in 1997 due to Bulgaria's debt burden[66]. However, additional reforms and improvements in collections from indirect taxes (e.g., VAT, excise) have significantly improved revenue performance, permitting the decline in direct rates initiated in 1999.

- **As in many transition countries, the effectiveness of data collection and accuracy of forecasting are undermined by the conversion of Bulgaria from a highly controlled and centralized system to one that has become less controlled, and where there are**

65 See "Bulgaria 2001," Merrill Lynch, March 6, 2001.

66 In the first half of 1996, 70 percent of expenditure was dedicated to debt service and guarantees for deposits placed in insolvent banks.

financial and economic incentives to withhold information to keep tax and other payments down. Declining incomes and purchasing power provide clear incentives to understate income at individual and corporate levels, and to rely on barter or off-the-books transactions. With an estimated 35-40 percent of GDP in the informal sector and about the same level of tax evasion, these incentives are still in place, complicating the effort to gather accurate data and to feed this into reliable forecasting. Over time, it is projected that continued real growth combined with lower tax rates will reduce obstacles to reporting and payments. However, this will still take time as long as incomes remain low for most people.

- **Regional and global considerations are now a part of fiscal policy due to Bulgaria's stated intention to become a full member of the EU later in the decade**. This requires having adequate tax administration and statistical systems in place, as well as ensuring adequate finances that include fiscal deficits not exceeding three percent of GDP on a sustained basis. On the latter point, Bulgaria has already achieved this capacity. However, statistical systems and the need for further improvements in tax administration remain projects on which the EU and Bulgaria intend to further cooperate. Problems at the National Statistical Institute include timeliness and veracity of data collected, and centralization of systems.

- **Budgetary processes and procedures are still generally centralized**. It can be expected that over time, some authority will devolve to *local* authorities. However, for the foreseeable future, fiscal matters are likely to remain centralized. The efficiency of the payments system reinforces this approach, as resources are easily transferred to/from outlying regions. Movement to RTGS will further improve these flows and associated record-keeping. EU support for SME and regional development may serve as a catalyst over time for partial administrative decentralization.

- **Fraud and corruption were reported to have contributed to the weak status of tax collections prior to 1997. Improvements in overall collections since suggest that improvements have been made in these areas**. In fact, the 2000 EU report on Bulgaria's progress towards accession reported that corruption and fraud remain problems for the government and economy. However, it appears that the problem is less severe than it was in 1997.

2.5. Exchange Rates

Bulgaria's exchange rate policy has been fixed to the DM and then Euro since introduction of the CBA. This followed a period in which the earlier Bulgaria lev had depreciated rapidly from 1995 to 1996[67], reflecting the earlier policies that relied heavily on borrowing and refinancing to prop up inefficient state industries and government operations.

The two basic weaknesses Bulgaria faces with the CBA are the inability to permit the currency to depreciate as a catalyst for increased investment and exports, and the current deterioration of exchange rates in relation to the US dollar. The latter is important due to the structure of Bulgaria's debt (which is about 65 percent dollar-denominated), and the international pricing of imported energy and other commodities in dollars. Meanwhile, as long as the Euro

[67] The exchange rate was BGL 487.4 per DM at end 1996, and as high as 49.4 at end 1995.

remains weak against the dollar, this will make debt service and the import bill more costly. Bulgaria also cannot pursue a currency devaluation policy to stimulate exports to its major trading partners in the EU. On the other hand, the CBA has benefited Bulgaria's economy with strict and predictable discipline that has squeezed out virtually all of the earlier leakage that brought Bulgaria to economic collapse in 1996. **The recent increase in FDI and export volume, combined with broadly favorable macroeconomic indicators suggests the benefits of the CBA have outweighed the costs during the last four years of stabilization**. Moreover, public opinion polls continue to show that the public firmly backs the CBA as a source of pricing and exchange rate stability. **Score: 3+**

- **On a nominal basis, the lev has depreciated against the dollar since 1999**. As the lev is pegged to the DM and Euro, its exchange rate has run parallel to the Euro markets. As of end 2000, the lev was 2.10 to the dollar. This compares with 1.95 at end 1999, 1.68 at end 1998, and 1.78 at end 1997.

- **Exchange rate depreciation had a moderately adverse effect on Bulgaria's 2000 balance of payments**. In particular, dollar-denominated energy prices drove up the current account deficit to 5.7 percent of GDP and added to the costs of production of most Bulgarian manufacturers who remain highly energy-dependent and -inefficient. Overall imports increased by 20 percent, much of it related to higher prices. Volume only accounted for about a 4 percent increase in total imports. In addition, about two thirds of Bulgaria's medium- and long-term debt is in dollars, while most of its foreign exchange holdings are in DM and Euros. Thus, with the appreciation of the dollar against the DM and Euro, Bulgaria has to absorb losses and higher costs.

- **The depreciation of the exchange rate is also considered to have been largely responsible for the higher than expected inflation rate**. The original target for 2000 was for an inflation rate of 6 percent. As of end 2000, year-on-year CPI was 11.4 percent.

- **Policy, design and implementation have been simplified with the currency board regime**. There are no longer open market operations directed by the BNB that could impact exchange rates. Local currency emissions are guided by the degree of foreign exchange cover provided. The advantage is one of interim certainty that fixed rates provide, and reduced seignorage. On the other hand, the currency board undermines flexibility, and severely curtails liquidity and lender of last resort options.

- **Bulgaria's fixed exchange rate linked to the DM (and the Euro) clearly reflects a policy anchored in EU accession goals as well as monetary stability**. Thus, exchange rate policy is focused on regional considerations that, by definition, reflect a larger goal to integrate into the global economy.

- **Risk management practices are disciplined but regulatory in practice. These practices will inevitably need to move from a regulatory to a market-based orientation**. Laws revised in 1996-97, associated regulations, and modernized approaches to banking supervision since then have put in place a disciplined framework for banking which reinforces exchange rate stability consistent with BNB's stated mandate of maintaining currency stability. Over time, it is expected that Basle-oriented guidelines for risk management practices by regulators and bankers will be integrated into the bank supervision process, along with other areas of financial sector activity and supervision. This has already begun to occur in insurance as well, which is responsible for contractual savings oversight. This should all support exchange rate stability over time. At a minimum, it should be consistent with Bulgaria's general effort to meet conditions for accession into the European Union.

- **There has been a significant remonetization of the economy since April 1997, and this provides sufficient coverage for a reasonably stable exchange rate**. Gross foreign exchange reserves increased more than DM 3 billion from April to December, 1997, and they have been sustained and increased since. By end 2000, foreign exchange reserves were more than double levels achieved at end 1997. Such reserves have been at the heart of the remonetization of the economy since mid-1997, and they represent a significant turnaround from the low of DM 610 million—or about $400 million—in January 1997.

2.6. Balance of Payments

Bulgaria's balance of payments has shown generally positive results in recent years. **While there has been an increase in the current account deficit, this is partly due to the increasing importation of goods being used to make manufacturing and services more competitive**. The results have already been manifested in increasing exports, primarily in petroleum products and footwear and leather goods. Meanwhile, interest service figures are higher due to dollar-denomination of the balance of payments. While this reflects the composition of debt and exchange rate movements, there has been no market concern about Bulgaria's ability to service or repay debt in a timely manner.

Since April 1997, Bulgaria's economy has remonetized, and this is showing up in improved capital account figures. There has been a significant increase in gross foreign exchange reserves. As of end 2000, these stood at $3.5 billion, or equivalent to about six months of import cover. By contrast, gross foreign exchange reserves were only $0.8 billion-equivalent at end 1996, roughly one month of import cover. This is all the more impressive as imports have grown steadily in recent years.

One of the major reasons for Bulgaria's stronger balance of payments position is the increase in foreign direct investment, even though portfolio outflows have been negative since 1998. In 2000, this amounted to $1 billion, or 8 percent of GDP, as compared with a mere $138 million in 1996, or 1.4 percent of GDP. While much of the FDI was previously put into the manufacturing sector, most of it related to the two major bank privatizations (UBB and Bulbank) in 2000. This will serve as a stimulus for domestic spending on MIS/IT and personnel, and have the larger effect of intensifying competition in the banking sector. Meanwhile, **the debt profile continues to improve**, with external debt declining from nearly 97 percent of GDP in 1996 to 86 percent at end 2000.

Overall, Bulgaria's balance of payments are showing improvement. The results achieved in the last few years stand in stark contrast to the balance of payments crisis through the current account in 1993, and finally the capital account via declines in reserves in 1996[68]. However, as

[68] The current account reached a deficit position of about $1.1 billion in 1993, or 10.1 percent of GDP. This led to some monetary and fiscal tightening in 1994-95, but structural weaknesses undermined the ability to enforce new incentive structures—patronage led to a substantial run-up of arrears; and refinancing from the central bank led to indefinite forbearance in the banking sector, and by extension, the real sector. These developments culminated in a reduction in foreign exchange reserves from $1.5

before, **Bulgaria runs the risk of slowing progress due to incomplete reforms at the structural level**. While the previous government was effective at curtailing financing of inefficient state enterprises, the new government will need to complete the reform effort in the enterprise sector (accompanied by major judicial reform for better private sector incentives) to sustain progress towards competitiveness. Short of that, **Bulgaria will be vulnerable to a slowdown in the Euro-zone economies**, particularly as its own domestic economy with 8.2 million people is still relatively small and limited in terms of aggregate long-term purchasing power. **Meanwhile, any export slowdown with its EU trading partners cannot be easily offset through trade, as nearly 25 percent of imports are energy products from Russia**. **Score: 2+/3-**

- **The balance of payments experienced a slight deterioration in 2000 as a result of exchange rate depreciation, but encountered no major problems in meeting payment obligations**. Nonetheless, there were some very positive trends. First, exports increased by 22 percent, reflecting improvements in some sectors' productivity and competitiveness, mostly textiles and mineral products. Second, Bulgaria experienced another increase in FDI, attracting nearly $1 billion in 2000 as compared with $789 million in 1999 and an average $522 million in 1997-98. In general, Bulgaria had no problem financing its current account deficit or debt service requirements[69]. Reserves approximated $3.5 billion, or six-seventh months of import cover.

- **Since 1997, there has been little net change in the dollar value of exports, and major performance improvements have been concentrated in two sectors**. While total exports for 2000 were $4.8 billion, the same as in 1997, they represent a major improvement over 1998-99 export figures that averaged $4.1 billion. The sectors showing the biggest gains since 1997 have been in the clothing and footwear and petroleum products sectors. These two sectors accounted for 16.4 percent and 11.2 percent, respectively, of total exports in 2000. This compares with 9.2 percent and 5.6 percent, respectively, in 1997. Most other segments have either declined, or shown limited incremental growth (in dollar values).

- **In contrast to exports, imports have grown substantially since 1997**. The most conspicuous growth has been in investment goods and consumer goods, while raw materials and energy imports (mineral fuels, oils, electricity) have shown limited increases in dollar values. Reflecting rising levels of direct investment, investment goods imports were $1.6 billion in 2000, as opposed to $822 million in 1997. Particular growth has been in vehicles and machinery. Consumer goods imports were valued at $1 billion in 2000, up from $474 million in 1997, and growth was recorded in all categories—food, drinks and tobacco, furniture and appliances, medicines and cosmetics, clothing and footwear,

---

billion in mid-1995 to a low of $400 million in January, 1997. By then, debt service accounted for 50 percent of government expenditure, and the only options were debt restructuring or a debt moratorium. The latter would have isolated Bulgaria from international markets for years.

[69] Current account movements were volatile in Bulgaria through 1996, and the limited reliability of data raised further questions about foregone information regarding imports and exports for goods and services. However, even with the information available, it was clear from 1991-93 that there was increasing pressure on the current account. This was financed largely by domestic debt that was run through the banking system. The dramatic drop in the current account in 1993 resulted from rising debt service payments due to heavy borrowing. As of 1995, the current account was revived with foreign exchange reserves used for short-term financing needs. However, by end 1996, this approach was undermined due to the collapse of available resources to finance external debt.

automobiles and others. Raw materials imports have also experienced growth, although on a far more modest basis. Chemicals and raw materials for the food industry have actually declined. In the energy sector, oil and gas have increased while coal and other commodities have decreased.

- **Bulgaria has generally succeeded in establishing an open and free trade regime, particularly since 1997-98 when it removed most non-tariff barriers. However, tariff rates remain high, complex and dispersed**. This has made trade harder to administer, and has provided a measure of protection to agriculture and heavy industry that has deterred their restructuring. Efforts are under way to simplify the system and to further reduce average levels of protection with the goal of being able to adapt to EU markets. As of 2000, Bulgaria's average MFN tariff rate was 13.7 percent, about double the rate applied by the EU (i.e., 6.9 percent). These rates are particularly conspicuous in sectors where Bulgaria needs accelerated reform to achieve competitiveness, namely in industry and agriculture[70].

- **Apart from energy imports, trade has gradually shifted away from the former Soviet Union to the market-based economies of Western and Central Europe**. Trade with the EU was about 50 percent of total in 2000[71], higher than Bulgaria's [33] percent in 199[6], but lower than most of the accession candidate countries. The signing of the Europe Agreement of 1993 has contributed to greater overall trade volume between Bulgaria and the EU. Bulgaria has also joined EFTA[72] and CEFTA[73], and concluded free-trade agreements with Turkey and FYR Macedonia. CEFTA trade in 2000 accounted for about 4 percent of exports and 9 percent of imports. Other free trade agreements with Lithuania, Latvia, Estonia and Israel are pending. More broadly, Bulgaria has bilateral agreements with about 75 countries in which most favored nation status is conferred.

- **Bulgaria's major trading partners by country are Italy, Turkey, Germany, Greece and Belgium for exports, and Russia, Germany and Italy for imports**. The five leading export destination countries accounted for 48 percent of total exports. In this regard, the 10.2 percent of total exports to Turkey in 2000 (nearly $500 million) may be partly jeopardized by the current problems faced by Turkey's economy. On the import side, the three countries provided about 47 percent of total imports. Russia accounted for 24.3 percent alone, mainly energy products. Again, there is potential risk to high levels of reliance on Russian energy supplies. Bulgaria's closer ties to NATO and recent expulsion of diplomats could aggravate relations with Russia.

- **Foreign direct investment reached $975 million in 2000, Bulgaria's highest level achieved**. Since 1998, FDI has totaled $2.3 billion, about 71 percent of the total $3.5 billion attracted since the transition to a market economy began. This represents a major success for the previous government, and indicates that international investors are showing

---

70 Average tariff rates for industry were 11 percent in 2000, and 24 percent in agriculture. This compares with the average EU rates of 4 percent and 15 percent, respectively, in industry and agriculture.

71 Exports to the EU were $2.5 billion, or 51.2 percent of total. Imports from the EU were $2.9 billion, or 44 percent of total.

72 This includes the Scandinavian countries and Switzerland, with Switzerland accounting for most of EFTA-related trade.

73 This includes the Czech Republic, Hungary, Poland, Romania, Slovak Republic, and Slovenia.

increasing interest in Bulgaria. Bulgaria still has some large enterprises to privatize in the telecommunications, tobacco, energy and other infrastructure-related firms. Thus, along with the fulfillment of earlier investment commitments, expansion of existing commitments, and greenfield operations, Bulgaria may be able to sustain such levels of FDI for the foreseeable future. Current projections show $4.5 billion in cumulative FDI from 2001-2006[74], or about $700-$800 million per year through 2006.

- **About half of FDI in 2000 resulted from privatization transactions in the banking sector**. The 2000 figure includes Euro 360 million (about $330 million) paid into the banking system by UniCredito for a 93 percent stake in Bulbank, Bulgaria's largest bank, and $207 million by the National Bank of Greece for a 90 percent stake in United Bulgarian Bank, Bulgaria's second largest bank. Additional investment into the financial sector could come if the privatization of Biochim and the State Insurance Institute take place in 2001. If CCB is privatized, it is not expected to generate major direct investment.

- **While foreign direct investment has grown, portfolio investment has experienced a net outflow of nearly $500 million since 1998**. This is largely a consequence of Bulgaria's limited domestic securities market and low yields. However, this is not new to Bulgaria, as portfolio outflows were already negative before[75]. As inflation has declined and fiscal deficits have been brought under control, rates paid on securities have declined. Thus, portfolio investors have generally fled the Bulgarian market in search of more lucrative opportunities in other markets.

- **Debt service requirements were fully met on a timely basis**. Bulgaria made payments equivalent to $1.2 billion in 2000, of which about $655 million was in principal amortization and $515 million was in interest payments. Together, these payments amounted to 9 percent of GDP and 18.4 percent of total exports.

- **Total stock of external debt at end 2000 was $10.4 billion, of which $9.2 billion was public or publicly-guaranteed**. This amounts to about 86 percent of 2000 GDP, as compared with nearly 100 percent of GDP in 1997. Most of Bulgaria's debt is owed to private creditors, mostly London Club creditors holding Brady bonds from the 1994 debt restructuring agreement. Total to private creditors was $5.7 billion at end 2000, or 58 percent of medium- and long-term external debt. Another $3.9 billion, or 41 percent is owed to official creditors, mainly the IMF, World Bank, and Paris Club bilateral creditors. In the period 2001-2005, Bulgaria's annual payments are projected to be $1.4 billion on average. Expectations are that these requirements will continue to be met on a timely basis.

- **Gross official reserves were equivalent to $3.5 billion at end 2000. This amounts to six months of import cover**. Thus, from a current account perspective, foreign exchange reserves are adequate. Where there is an inconvenience in terms of the balance of payments is with regard to exchange rate movements and how these affect the currency composition of debt and denomination of import prices (especially energy), as compared to the currency composition of foreign exchange reserves held by BNB. Medium- and long-

---

[74] See "Bulgaria: 2000 Article IV Consultation", IMF, March 2001.

[75] Portfolio flows have been conclusively negative in Bulgaria for years, despite a short-term increase on a flow basis in 1997 followed by a net outflow from 1998 on.

term debt was 65.6 percent dollar-denominated at end 2000[76], and energy prices are globally denominated in dollars.

Table 5. Balance of Payments Indicators					
(millions of US$)	**1996**	**1997**	**1998**	**1999**	**2000**
Merchandise Trade Balance	122	321	-381	-1081	-1173
Current Account Balance	131	288	-62	-685	-696
Portfolio Flows, net	-129	133	-180	-199	-168
Direct Investment	1,111	274	625	1,141	-277
o/w Foreign	137	507	537	789	973
o/w Domestic	974	-233	88	352	-1,250
Capital Account	-887	156	181	731	796
External Debt	9516	9732	10025	9890	10371
Foreign Exchange Reserves	793	2474	3056	3222	3460
FX Import Cover (months)	1.0	4.6	6.1	5.9	5.1
Trade Balance/GDP	1.2%	3.2%	-3.1%	-8.7%	-9.7%
Current Account/GDP	1.7%	10.3%	-0.5%	-5.5%	-5.8%
Portfolio Flows/GDP	-1.3%	1.3%	-1.5%	-1.6%	-1.4%
Direct Investment/GDP	11.3%	2.7%	5.1%	9.2%	-2.3%
o/w Foreign/GDP	1.4%	5.0%	4.4%	6.4%	8.1%
o/w Domestic/GDP	9.9%	-2.3%	0.7%	2.8%	-10.4%
External Debt/GDP	96.8%	95.9%	81.8%	79.7%	86.0%
FX Reserves/GDP	8.1%	24.4%	24.9%	26.0%	28.7%

Sources: BNB; IMF (IFS)

76 This is down from 71.6 percent in 2000.

III. BANKING STRUCTURE AND SYSTEM PROFILE

Bulgaria was at the beginning of the adjustment process in the banking sector in 1997. Major legal and regulatory reforms were introduced in 1997-98. Technical assistance was on the ground to shore up institutional capacity in banking supervision, and to help establish a plan and implement bank privatization. At the time, it was hard to even get a sense of basic asset values, given hyperinflation, the lack of active and transparent markets for fixed assets, and the deep problems of the loan portfolio. There was virtually no concept of risk management in place (apart from a few of the major foreign banks that had established small banks or branches), and the incentive structure was geared to political patronage and forbearance rather than commercial viability and cash flow.

Since then, conditions have vastly improved. Five of the six major banks slated for privatization have been privatized, and the last remaining bank is not a major bank. **While four other banks remain state-owned and should be privatized, 80 percent of the banking system is now privatized and largely foreign-owned. Banks have high capital adequacy ratios, and asset quality is better than a few years ago.**

Recent foreign investment is serving as a catalyst for increasing competition in the small corporate market, and for new investment in retail expansion that is expected to significantly increase the penetration rate of banks in the enterprise and household sectors. New systems are being put in place to manage associated risks. These investments and systems are expected to add to product offerings, with the anticipated effect of growing bank balance sheets and increasing intermediation levels. All of this should spur on continued economic growth.

While growth and intensified competitiveness are projected, consolidation is also projected. With 35 banks, Bulgaria is likely to see this number decline in the coming years. There is nothing wrong with this development. In fact, this should help, as many of the banks have low levels of aggregate capital, and little to offer the marketplace in terms of loan size or non-credit services apart from rudimentary safekeeping.

In anticipation of these developments, **one of Bulgaria’s most critical needs is to devise a strategy for bank resolution**. This can be done in a number of ways. One approach is to create incentives to consolidation prior to the risk of deteriorating bank-specific financial conditions. Raising levels of minimum capital is one technique. Regulatory inducements are another. Short of that, BNB and the government will need to think through the potential economic cost of having a large number of small banks that could potentially engage in practices that could harm system stability overall. Nonetheless, for the time being, this does not appear to be a major risk. Overall, the banking sector is now financially stable and poised for growth.

By contrast, in the non-bank sector, little has occurred. The securities markets are weak and characterized by low turnover and market capitalization. The insurance sector is underdeveloped and in need of a strategic framework to ensure that companies are financially sound, committed to observing standards of consumer protection, and able to properly monitor the risks associated with their underwriting practices. **Recent pension reform bodes well for private savings, although there are doubts about the size of voluntary contributions to be made in the coming years as long as purchasing power remains relatively low**. Meanwhile, mandatory contributions will also be sub-optimal until tax avoidance/evasion declines to more modest levels. If contributions do not reach targeted levels, **the authorities will need to also have a contingency plan in place in the event that one or more private pension funds come under financial stress. This is also the case in the insurance sector** if a firm is financially troubled and unable to honor claims. Beyond that, there are opportunities to develop leasing, factoring, commercial finance, mortgage lending and other financial services. However, these markets remain largely underdeveloped.

The quality of management and governance varies, although standards are largely improving with modernization and competition. While the foreign-owned banks and many of the more competitive domestic banks are considered sound in terms of board composition, management capacity, internal controls, and systems, there are other banks that are not considered as strong. Without regulatory controls, some of these banks would otherwise pose a potential threat to systemic stability. In the meantime, many of the older banks that have not attracted new capital and shareholders are reported to require improvements in board composition, management capacity, organizational structure, and quality of information. Some of these problems can be remedied by introducing independent and outside board members (particularly for Audit Committee participation), increasing checks and balances in management roles and responsibilities, reconfiguring existing top-down structures to be more horizontal in their functions, establishing better channels of internal communication, and maintaining closer and more regular links with external auditors.

The new government will need to address the "strategic framework" issues in a more organized fashion now that they have embarked on accession negotiations with the European Union. Several market players and others have commented that legal and regulatory changes are haphazard and frequent, and that this undermines confidence and planning for the future. Specific examples of policies that work at cross-purposes, or problems associated with the need for better harmonization across financial products and services are commonly noted. Now that the system has stabilized and the financial sector is poised for growth, it may be in the interest of government policy makers, various financial regulators, and market players across the financial services industry to participate in a comprehensive strategic framework exercise to smooth out these inconsistencies. While broad in scope, this would likely provide the needed clarity of freedom and maneuverability for financial institutions at a time when they are planning for growth and expansion. **Score: 3-/3**

3.1. Overview

Bulgaria has made impressive progress since 1997 in stabilizing the banking system, and putting it in a position for growth and diversification. The system is now dominated by strong regional banks (from Italy, Greece and Austria), supplemented by prime-rated global banks (from the Netherlands, France, Germany and the U.S.). While the system is still small, at less than $5 billion in total assets, it is poised for growth due to high capital and liquidity ratios, and relatively clean loan portfolios.

There are clear indications that bankers have confidence in Bulgaria's future prospects. As an example, many of the global players are currently investing in retail networks, rather than keeping their operations focused on low levels of risk and off-balance sheet activities. While banks have been criticized in recent years for not lending, they are now tooling up to do more than lend. Their current agenda is to provide a wide variety of products and services to enterprises and households, with the intention of diversifying their earnings stream and moving away from passive, low-return investments in low-risk securities and paper (mainly abroad).

Increasing competitiveness is likely to improve overall offerings and service levels. Nonetheless, it will also put pressure on the weaker banks. **With 35 banks in Bulgaria, about half of which are either small and/or weak, it is expected that many of these will disappear in the coming years**. There is a risk that such pressure could lead to political patronage, selective forbearance, and other practices inconsistent with market-based rules of engagement. There are several other risks that could materialize as a result of such pressure, including losses resulting from adverse selection, aggressive pricing on deposits to increase funding unavailable in the inter-bank market, and imprudent use of lender of last resort provisions. **A clear, consistent and sound framework for bank consolidation and resolution needs to be developed in anticipation of such possible developments**.

Donors also present a risk, as subsidized loans can lead to market distortions and support for institutions that otherwise would not survive. Extraneous investments for portfolio purposes can also encroach on market development. Thus, **given that the market is now poised for real growth, donors' involvement should be less on direct financing of projects through institutions (or on equity investments in the already over-capitalized banking sector), and more on building the needed infrastructure (e.g., laws, regulations, institutional capacity) for market development to proceed under stable conditions**. **Score: 3-**

- **Foreign ownership and privatization have constituted the major changes in banking since 1998**. The biggest change in the composition of capital has been in the role of foreign investment into the sector. At the end of 1997, Bulgaria had a limited foreign presence in the banking sector—ING, Raiffeissen, and BNP-Dresdner[77] were the major foreign banks in Bulgaria. However, the previous government stated its intention to attract strategic investment into the sector with the privatization of six state-owned banks. This has effectively occurred, including most recently with the 93 percent ownership stake by UniCredito of Italy in Bulbank, Bulgaria's largest. Meanwhile, only Biochim remains to be privatized among the six major banks slated for privatization in 1997. The government was negotiating the sale of Biochim to Hebros, but these discussions failed to lead to an agreement. The government has also announced its intention to privatize two of the three remaining banks—DSK (the former savings bank), and the Central Cooperative Bank (CCB). However, this may not occur any time soon due to the restructuring needs of DSK. Raiffeisen has submitted a plan for the absorption of CCB, but it is unclear if this plan will be accepted. There have been no stated plans to privatize Promotional Bank.

- **There has not been much consolidation of the banking sector since 1997**. Bulgaria had 35 banks (including branches of foreign banks) at end 2000[78]. This has hardly changed from 1997, when there were 33 banks. In 1997, many of the smaller Bulgarian banks were reported to be below the minimum capital requirement. Ordinarily, this would have prompted mergers or closures. However, it was also reported than many of the owners and managers of these banks did not want to merge. Eighteen banks have been closed down since 1996, although the definitive resolution of about 10 of them has been stymied by ineffective court-oriented bankruptcy procedures that have drawn out the process for years. In the meantime, Group IV[79] banks' total capital averaged only 18.6 million leva (less than \$9 million), barely above the regulatory minimum of 10 million leva. As these

[77] BNP and Dresdner cordially ended their joint venture banks in the region in late 2000. BNP-Paribas is operating in Bulgaria. Dresdner is expected to renew operations at some point after the Allianz acquisition is finalized in mid-2001.

[78] Société Générale is in the process of closing its branch now that it owns SG Expressbank.

[79] Neftinvestbank, Bulgarian-American, Eurobank, Unionbank, Corporate Commercial, Demirbank, Tokuda, First East International, International Commercial, Teximbank, Bulgaria-Invest, Promotional, and International Bank for Trade and Development.

banks have the poorest performing credit portfolios[80], the strongest among them may be candidates for consolidation while the weakest among them could be candidates for closure in the future. In the meantime, Group III are often among the most aggressive banks, and may seek to acquire or merge with other banks to increase capacity and market coverage.

- **Concentration within the system may be diminishing, although it still remains fairly high**. The three Group I banks accounted for 50 percent of total assets, 51 percent of total deposits, and 53 percent of total capital and reserves at end 2000. Bulbank remains Bulgaria's largest bank, with about $1.2 billion in assets, or 25 percent of total. Because of substantial immobile assets and the absence of adequate accounting in 1997, it is unclear how this market share relates to figures in 1997. However, at the time, Bulbank was estimated to account for about half of banking system assets, although many of these assets were non-performing and have since been written off. Likewise, the State Savings Bank (DSK now) reportedly held about 50-60 percent of local currency deposits in late 1997. At end 2000, DSK held 32 percent of local currency deposits and only 14.5 percent of total deposits. Thus, concentration remains high, but appears to have diminished since 1997.

- **On the other hand, there are many small banks that may not be able to compete over time**. Among Bulgaria's 35 banks at year end 2000, only 14 had 2 percent or more of total system assets. While many of these are strong banks from abroad that are just beginning to get established in the Bulgarian market, there are many others that are simply small banks after years of operation. These are generally Group IV banks that will face market share and profitability challenges in the coming years. Some (but not all) of these banks are considered good institutions could be attractive candidates for consolidation with other banks.

- **Lending volume is low, but credit quality has improved**. Credit[81]-to-GDP was 12.5 percent at end 2000, which is relatively low by regional and EU standards. For instance, by comparison with the nine other transition candidate countries, the average unweighted credit-to-GDP ratio was 24.5 percent in 2000, although Bulgaria's figures were higher than in Lithuania and Romania. The same figure for OECD countries was greater than 100 percent in 2000, of which EU banks represented a major share. Total loans net of investments in bank paper and government securities approximated $1.4 billion. However, for the loans made, 92 percent are standard in Bulgaria, and only 3.4 percent were classified as loss loans at end 2000. This represents a significant improvement in overall credit quality, largely due to the predominance of placements in government securities and bank paper.

- **After adjustments for quality differentials, the total volume of loans to the real sector was probably about the same level at end 2000 as it was at end 1997, or slightly less**. Bulgarian banks had 3 billion leva ($1.4 billion) in outstanding loans (net of claims on

---

[80] Group IV banks' credit portfolio was only 80.3 percent standard, as opposed to the banking sector's overall average of 91.8 percent at end 2000.

[81] Credit is defined as loans to the real sector and inter-bank market (defined as local currency claims on banks and other financial institutions), and does not include investment in securities or placements in paper abroad. If total claims on banks and other financial institutions are added to the total, credit was 27 percent of GDP.

banks and other financial institutions) at end 2000, compared with 3.4 billion leva ($1.9 billion) provided at end 1997[82]. However, the numbers are not directly comparable, mainly due to differences in credit quality. A significant portion of the 1997 loan stocks were non-performing and subsequently written off, whereas in 2000, this was not the case. For example, 92 percent of bank loans were standard as of end 2000, far higher than the 79 percent shown at end 1997[83]. Loss loans were 3.4 percent of total at end 2000, as compared with 12.9 percent at end 1997. Writing off loss loans would bring 1997 loan figures down to 3 billion leva, or $1.7 billion[84]. The same approach would show loan figures at end 2000 to be 2.9 billion leva, or $1.4 billion. The gap is probably less than $300 million because the 1997 loan figures also showed higher levels of sub-standard and doubtful loans (4.7 percent of total) that later became loss loans, as opposed to 2 percent at end 2000.

- **Lending to the private sector is likely to increase in the coming years as banking competition heats up, retail networks expand, marketing strategies become more sophisticated, businesses become more credit worthy, institutional infrastructure become more developed, and legal enforcement is conducted on a more creditor-friendly basis**. Overall lending to the private sector increased from 2.1 billion leva ($1.1 billion) at end 1999 to 2.9 billion leva ($1.4 billion) at end 2000. This partly reflects the emerging focus of banks towards an expansion of earnings and assets now that they have broadly stabilized after the 1996 crisis. There is evidence that some of the banks, including those that have attracted strategic and foreign investment, are moving towards retail growth through expanded branch networks and electronics. Businesses are becoming more knowledgeable of banks' requirements for loans, business advisory services are increasingly available to SMEs, credit ratings on borrowers can be obtained, property registries are established, and recent legal reforms regarding the Law on Pledges are intended to make the environment more conducive to lenders. In addition, other factors such as security, convenience, quality and speed should also improve with the presence of strong regional and global banks in Bulgaria, many of which are committed to the retail market.

- **As competition intensifies in the corporate sector, banks will look to the consumer market to increase margins**. Given the limited number of "blue chip" firms in Bulgaria, most of the economy is based on SMEs and household operations. Banks will look to the consumer and SME market to increase their earnings, both from better margins on loan products, and from other services (e.g., cash management, treasury management, payroll services, trade finance). However, for the interim period, this market's attractiveness will be limited due to the low purchasing power of the vast majority of people.

- **Meanwhile, lending to the state sector will continue to diminish**. Credit to state enterprises was only 117 million leva ($56 million) at end 2000, a mere 4 percent of total

82 Figures from 1997 are derived from *International Financial Statistics*, and include only claims of deposit money banks on private sector enterprises and households, and non-financial public enterprises. Claims on other financial institutions are not included.

83 BNB credit figures include banks' claims on other banks and financial institutions. The loan figures cited in the text do not include these. Rather, they focus on loans to households and enterprises.

84 Netting out loss loans = 2,966 million leva. With a year-end exchange rate of 1.78 leva per $1, this brings the 1997 loan figure to $1.67 billion.

credit to non-financial institutions. Likewise, credit to the budget was practically zero. These figures are a fraction of 1999 figures, reflecting the downward exposure of the banks to the public sector. Where there is exposure is in the form of investments in government securities. However, these are also limited at about 437 million leva ($208 million) at end 2000, equivalent to about 4.4 percent of total banking system assets.

- **The issue of off-balance sheet items appears to have been addressed without any major disruption to the banking system**. In late 1997, rough estimates indicated that state banks' contingent liabilities *exceeded* their total assets, and were more than 13 times total capital. Much of this dated back to earlier guarantees for which the banks were potentially liable. Presumably, most of this related to Bulbank as the major foreign trade bank. As of end 2000, total system contingent liabilities were 1.1 billion leva, equivalent to less than 12 percent of total assets and 76 percent of total system capital[85]. There is still a risk that several banks have issued guarantees that would be difficult to honor. However, by and large, most off-balance sheet items are reported to be credit guarantees, letters of credit, bankers' acceptances, unused lines of credit, and basic foreign exchange cover. There is ample capacity among banks to absorb these liabilities should they require direct financing.

- **In terms of funds flows, banks generally rely on deposits for funding, invest in bank paper and government securities (76 percent of deposits), and then lend to enterprises and households (42 percent of deposits)**. Reserve requirements were lowered to 8 percent of total deposits in July 2000 from 11 percent, providing incremental funds for earnings deployment. Most of this is reported to have been placed abroad with foreign banks. Total deposits are concentrated in Bulbank, DSK, UBB, Postbank, Biochim, SGExpressbank, Hebrosbank, and BNP-Paribas. Combined, they account for 75 percent of total mobilized deposits. The total inter-bank market was estimated to be about 182 million leva at end 2000[86]. These banks supplied most of the funds for that market to operate.

- **There is currently limited demand for services from banks beyond basic safekeeping, although this is beginning to change**. Bulbank provides a range of financing and fee-oriented services for foreign trade, as shown in its figures from foreign exchange trading and related operations. Debit cards have become fairly prominent, and credit cards are being issued for salaried employees. The major foreign banks and branches are able to provide a full range of services, although demand for such services has been fairly limited to date. This is reflected in the low earnings from non-lending activities for all banks apart from Bulbank. Meanwhile, there is little lending, and deposits still receive negative real interest rates. However, as companies become more competitive and management improves, they are beginning to identify a greater number of services they can utilize from banks. Moreover, banks are beginning to market and compete more aggressively, which is also making it more feasible for companies to think about how they can benefit from relationships with banks.

---

85 For Bulbank, this now appears to present no major problems. Off-balance sheet items were only 8.1 percent of assets and 48.6 percent of capital at end 2000. Thus, Bulbank appears to be less exposed to risks in this regard (based on aggregate numbers) than the system as a whole.

86 BNB reports claims on banks and other financial institutions as one line item by currency. Local currency claims are used as a proxy for the inter-bank lending market, while foreign currency claims are generally assumed to be placed abroad for short-term investment purposes.

- **Due to the limited demand for non-credit services, relatively low levels of lending, and fairly modest returns on investments, banks were profitable in 2000 but hardly outstanding in terms of performance**. Bank earnings in 2000 were net 283 million leva, or about $133 million. This translates into 20.3 percent return on average capital (including reserves) and 3.1 percent return on average assets. These returns would be perceived as strong in more advanced financial markets, largely due to the volume base available, and the costs associated with risk management, proprietary technologies, product/market research, and other core aspects of banks' operations. However, for Bulgaria, these returns are based on a small level of volume and a clearly cautious approach to risk. While these measures are satisfactory and consistent with incentives of the prudential framework, they do not provide the level of earnings needed for a major expansion of banking assets and services. This may change as the foreign owners of recently privatized banks become better acquainted with the market, and as the economy continues to show growth under stable macroeconomic conditions.

- **Increasing use of ratings by internationally recognized rating agencies is expected in the coming years now that major banks are privatized, and with increased global attention on capital adequacy and liquidity positions in emerging markets**. In 1997, there were no ratings available on Bulgarian banks. This has begun to change, as Fitch IBCA Duff & Phelps rated UBB in December 2000[87]. Future ratings can be expected for Bulbank, Postbank, and others, particularly in the future if these banks seek to increase funding through syndicated borrowings and/or shares.

- **Bulgarian banks have adequate correspondent networks and payment/settlement systems**. The major banks generally have foreign share ownership, so this is even less of an issue than it was in 1997. Significant resources are deposited abroad, which also facilitates international payments and settlement. At end 2000, these were 3.7 billion leva ($1.8 billion), about 38 percent of total assets and more than half of total deposits.

---

[87] UBB's outlook was viewed as stable. Its short-term rating was "C", ad its long-term rating was "B+". See www.fitchibca.com for a description of ratings.

3.2. Ownership

The banking system has gone through a major reconfiguration of ownership since 1997. As of end 1997/early 1998, the banking system was heavily weighted towards state banks. Since then, most of the major banks have been privatized, primarily by attracting strategic investment from abroad. This transformation includes the sale of nearly 100 percent stakes in Bulgaria's two largest commercial banks in 2000 to Italian and Greek banks. At least another 20 banks are at least partly foreign-owned, accounting for a total of about 70-75 percent of banking system assets.

At the end of 2000, only about 20 percent of assets remained in state-owned banks. This is in stark contrast to the 82 percent share at end 1996 and 66 percent share at end 1997 (due to the closure of smaller insolvent banks). Of the remaining state-owned banks, two (Biochim and Central Cooperative) have already begun initial privatization discussions. A third, DSK, is the former state savings bank that operates under a fairly narrow set of restrictions with regard to lending. A fourth, Promotional Bank, was established to encourage lending to SMEs. **It would behoove the new government to move forward as rapidly as possible with privatization of these state banks to avoid the risk that they could be used in the future to revive earlier practices of connected lending[88]. Score: 3+**

- **One of the most dramatic changes to the Bulgarian economy since 1997 has been the degree of privatization of the banking system**. At end 1997, there were 33 banks in Bulgaria, of which six were state-owned. As of end 2000, there were 35 banks, of which only four had majority or minority state and/or BCC ownership. Whereas in 1997 the structure of the banking system was still primarily state-owned[89], at end 2000 private banks accounted for about 80 percent of total system assets. The two largest banks—Bulbank and United Bulgarian Bank (UBB)—were sold to strategic foreign investors in 2000. These two banks alone account for 3.7 billion leva in assets (nearly $1.8 billion), or 38 percent of total. Only DSK (the former state savings bank), Biochim, the Central Cooperative Bank (CCB) and Promotional Bank remain state-owned[90]. Together, these four account for 1.9 billion leva in assets ($913 million), or 19.6 percent of total system assets.

- **Of the four state-owned banks, two have at least begun the process of prospective privatization**. The Bank Consolidation Corporation was negotiating the sale of Biochim to Hebros Bank, although this transaction was not approved and a third effort to sell the bank is expected to commence later in 2001. Meanwhile, Raiffeisen has submitted a proposal to purchase a controlling share of CCB, in which the state is a minority shareholder. However, Raiffeisen's position is that it would want a majority and controlling position, so

88 While insider transactions also occur in some of the private banks, the state is generally under less pressure to cover the costs of private bank losses than it is at state banks.

89 Estimated asset shares of state banks were 70-75 percent of total in 1997. There were six state banks at the time, 16 private Bulgarian banks, and 11 foreign banks and branches. Respectively, these groupings were broken out into Group I, II and III by BNB. At mid-1997, the large state banks (Group I) accounted for 76 percent of total assets, while private Bulgarian banks (Group II) had 10 percent, and foreign banks (Group III) had 4.5 percent. The balance of 9.5 percent was accounted for by an additional 16-17 banks set for liquidation.

90 The state owns 34.3 percent of CCB, but is the majority owner of DSK, Biochim and Promotional Bank.

it is unclear if the plan submitted will ultimately be accepted. This plan was submitted in late 2000, and adjustments would need to be made subsequently as a result of diminishing deposits in the bank. However, should these privatizations proceed at some point, this would signal some consolidation in the sector, and removal of the state in all but two banks.

- **There has been a significant shift to foreign ownership of the banking system in Bulgaria**. Of Bulgaria's 33 banks at end 1997, 22 were domestic banks. These banks accounted for 95 percent of total bank assets. However, since then, Bulgaria's banking system has attracted investment from foreign banks, including some prime-rated banks. As of end 2000, the role of foreign banks—both in numbers and financial activities—has increased substantially. At end 2000, banks either foreign-owned or partly owned by foreign banks accounted for at least 70 percent of assets. However, it should be noted that some of these owners were not "prime-rated" in terms of investment instruments or international recognition. Likewise, some of the major investors were, in fact, state-owned, such as the National Bank of Greece, which acquired UBB, Bulgaria's second largest bank.

- **There is a risk that continued state ownership in the banking system will create market distortions or a resumption of practices that can potentially cause problems for these institutions and the market as a whole**. While the government has shown discipline since 1997, DSK has a well developed branch network that can be used for political patronage purposes. As the former state savings bank, privatization of this bank can be delayed for many years on the basis of its usefulness as a delivery channel for on-lending, social funding, etc. The longer the bank remains state-owned, the longer the possibility that its franchise can be used for non-commercial purposes. Likewise, the Promotional Bank, while small, was established to finance SMEs. This bank receives donor funding, and can conceivably be used for directed lending, soft lending, and other purposes that compete with and, in some cases, undermine the market.

3.3. Governance and Management

Governance and management have improved in most banks since 1997, although there are still reported to be many weaknesses at the smaller banks. Positive developments include the risk management expertise that has been a part of foreign bank privatization, improved MIS, investment in IT, development of the internal audit function, increasing use of international standards of accounting and audit, and stricter qualifications required of board members. Much of this derives from improvements and changes that were introduced through laws and regulations adopted in 1997-98.

In terms of governance, there is a commitment to holding boards responsible for the business plans of their banks, satisfactory internal controls and reporting, and compliance with laws and regulations. Management is expected to implement these plans accordingly. **The larger task now is how banks will manage risks as conditions become more competitive**. This transcends fundamental credit risk, and is likely to take on a more consolidated profile over time as banks eventually enter insurance markets, increase their roles as investment intermediaries for private pension funds, and expand their activities in the capital markets (via brokerages as well as potentially as institutional investors). For smaller banks where management capacity may not be as deep, this challenge is likely to create additional operational and informational problems that will need to be tackled to ensure risks are under control.

These will also be critical challenges to BSD at BNB, both for off-site surveillance and the workings of the early warning system, and the on-site department to follow up on a timely basis with targeted examinations. As banks diversify, this will also require sound and timely coordination among the various financial services regulators. The hiring of BNB personnel by some banks may help with regulatory and systems compliance, and the internal audit function. If so, this represents a contribution to corporate governance and management capacity in the banking sector. This will likely be tested in the coming years. **Score: 3-**

- **The legal process for joint-stock company formation and registration is fairly straightforward and inexpensive, and takes about one to three months. The is about how long it takes for banks to receive a license, assuming they make all the proper submissions and meet all BNB criteria**. This represents an improvement from 1997, when the process for banks was more complex[91]. The Law on the Bulgarian National Bank is clear and reasonably detailed with regard to the incorporation and management of banks, including the issuance of shares and the requirements and qualifications of board members. Meanwhile, the Law on Banks spells out board responsibilities and requirements, including internal controls and the disclosure of information. This includes notification of BNB if any violations are found with regard to bank governance and practices that may result in material adverse effects on or losses to the bank. Any acquisition of more than 5 percent of voting shares in a bank needs to be approved by BNB. The Laws also stipulate that BNB is given six months to approve a license application, although they have done so more quickly with many of the foreign banks (particularly if prime-rated).

[91] In 1997-98, there was an unofficial policy to not issue new bank licenses as an incentive to prospective investors to acquire state banks. This was policy was also pursued by Poland from 1992-95. Both countries ultimately managed to attract high levels of foreign investment, although this was after the restricted licensing policy had been abandoned.

- **Cross-ownership is permitted but restricted in the Law on Banks**. The BNB has been fairly strict about explicit ownership by banks in non-bank companies, although insurance firms have invested in banks. Moreover, banks are investing in private pension funds, and can be expected to invest in insurance companies in the coming years once legally permitted. Banks have partly avoided restrictions, mainly in the use of insurance requirements for collateral as a condition for making loans. However, the situation is a bit different now than in 1997. Today, several large and foreign banks are competing, and several have experience outside Bulgaria in properly overseeing subsidiaries to ensure the core bank operation is not weakened on a consolidated basis. This contrasts with the banking system prior to 1997, where cross-ownership was common and insider lending triggered eventual collapse and insolvency. As the financial services market develops, it can be expected that banks will take on a more universal character, and that cross-ownership will become more common. However, for the time being, banks are not permitted to be general partners in commercial companies, and BNB is being cautious with regard to bank expansion into non-bank activities. At some juncture, more explicit criteria will need to be developed to clarify the basis for selectivity and differentiation. BNB is correct to deny entry by some banks into risky non-bank activities if they lack the management, capital, systems and experience to properly manage those risks. However, clearly mapped out criteria may need to be disclosed.

- **Constraints to lending are largely due to governance and management problems in the real sector, and difficulties associated with judicial enforcement**. Businesses in Bulgaria tend to be sole proprietorships, where governance and management are not always effective. In this regard, the prevalence of MEBOs and slow pace of small-scale privatization have hindered improvements in business sector competitiveness among long established firms. Tax avoidance and aversion also translate into problems of disclosure, accuracy and verification for banks in assessing credit risk and following up on recoveries. In response, banks generally collateralize their loan exposure at least 150-200 percent. However, there are problems with secured asset valuation due to the limited secondary market, asset stripping, the ability to possess assets in a timely manner due to time-consuming bailiff and court procedures, and the ability to sell seized assets due to the erosion of quality over time. The Law on Banks notes that banks have the right to obtain a writ of execution when a loan is not repaid at maturity, and to auction these assets off under special procedures. This includes mortgages on real estate. However, banks have faced many difficulties on these issues, largely due to resistance in courts and a less than interventionist approach by BNB when disputes arise with regard to property rights and contract enforcement. Ultimately, most lending is done on a "character" basis. Bankers appear to communicate with each other on prospective loan quality issues.

- **One of the weaknesses that affects some of the smaller banks appears to be management and governance**. This is largely due to lack of experience in well developed market economies, and differences in traditional practices and relationships that have produced insider deal, connected lending, and other practices that can weaken financial performance. Many of the smaller banks lack the kinds of MIS that larger banks have, and they are not always as well trained in modern risk management practices. Qualifications of supervisory board members are not always appropriate or complete for oversight of management, and some banks are reported lack sufficient checks and balances in their management structures. This is rooted in the earlier vertical structures in which decisions were largely centralized at the top. By contrast, the more modern banks rely on a greater degree of horizontal functionality, with specialists and departments inter-facing to determine risk-reward positions.

- **Shareholder protection needs to be strengthened in Bulgaria**. Majority and minority shareholders can be easily manipulated by management through the use of "shrinking quorum" measures, scheduling conflicts, and insider deals. In theory, shareholders are entitled to pre-empt the issue of new shares that would dilute their stakes. However, weak internal audit functions, poor information and data, weak qualifications of board members, weak disclosure and widespread insider trading all undermine shareholder protection (and capital markets development). The general market view is that strategic investors need to have management control, and 100 percent (or nearly 100 percent) ownership for full and effective operational control. In some privatization transactions, investors have failed to protect themselves by omitting pre-emptive clauses in their legal agreements that would have provided them with recourse after problems resulting from flawed due diligence were uncovered.

- **Shareholders are permitted to vote by proxy at company meetings. However, companies are not required to send proxy forms to shareholders in advance of meetings**. The Law on Banks addresses the role of the internal audit function as well as external audits, and this has provided some improvement in the oversight of bank management. There are now strict guidelines for directors to exercise governance in compliance with laws and regulations. The strengthening of bank supervision has partly focused on the effectiveness of corporate oversight of banks. However, governance is still viewed as weak, particularly in the real sector.

- **There are no restrictions on compensation—salaries and benefits—of bank directors, managers and employees**. There can be restrictions placed on compensation if a bank is facing problems, but otherwise there are no restrictions. Compensation is expected to be in line with market norms, and not undermine the solvency or liquidity of the individual banks. There is evidence of increasing competition for bankers and bank supervisors. Meanwhile, based on general salary/wage data, financial services were the most highly compensated sector of the economy.

- **There are restrictions on the payment of dividends to shareholders**. If capital and reserve ratios fall below minimum levels[92], dividend payments cannot be made. There are also restrictions on dividend payments if tax payments are due. However, if these conditions are met, large dividends can be paid out. UBB and Bulbank, both of which were privatized in 2000, paid out large dividends despite the new owners being on site for only a matter of weeks (Bulbank) or months (UBB).

3.4. Non-Bank Competition

There is still limited competition for and complementarity to banks in the marketplace, which has also perpetuated the notion that banks should provide the vast

[92] Minimum risk-adjusted capital ratios are 12 percent. General reserves are required to be at least 1.25 percent of total assets. BNB also sets reserve requirements—8 percent as of early 2001.

majority of funding for enterprises. It is not uncommon to look to banks to play this role, particularly as traditional universal banks in continental Europe tend to play a more concentrated role in the financing of enterprises than in other markets. Nonetheless, with the introduction of modern prudential norms, banks are simply unable to provide the amounts of financing demanded, even if the banks would like to. This is due to basic restrictions on large loans, concentrations of exposure, etc.

Among other financial services, **the capital markets are weak in Bulgaria**. They are characterized by low turnover, which is all the weaker on average due to the disproportionate role of block trades on an otherwise illiquid market. Market capitalization for the entire Bulgarian Stock Exchange was less than $500 million at end 2000. Future moves to increase regional links, enhance OTC opportunities, and make trading more transparent would all help with securities market development.

Contractual savings instruments are beginning to appear, particularly with recent pension reform. Bulgaria introduced reforms in 2000 to move to a sustainable three-pillar scheme. Since then, nine active pension funds have attracted more than 400,000 insured and $35-$50 million to their voluntary funds in the first year or so of operation. While this signifies progress, it is unclear the degree to which people born after 1959 will continue to make contributions for future retirement benefits should their purchasing power remain relatively low. Meanwhile, insurance activity is beginning to increase, including in the life insurance sector. Life insurance was about one third of total premium revenues in 1999, or about $100 million-equivalent. It will take time for contractual savings instruments to capture sizable market share, and for these funds and companies to be in a position to play a major role as institutional investors.

There is limited development of factoring, commercial finance, leasing or other types of financing that could serve as either competitors to or partners of banks. Some bank financing of leasing activities occurs, and some of the banks' lending to companies is comparable to commercial finance in more developed markets. There has been some initial mortgage lending, although this has not become a major activity yet for banks or non-banks. **Score: 2**

- **The Bulgarian capital markets are characterized by low turnover, low levels of market capitalization, and questionable transparency**. The Bulgarian Stock Exchange (and markets for government securities and foreign exchange) officially reopened in October 1997 after new depository and registration standards were introduced in 1996. By January 31, 1998, block trades of 140 different companies were being transacted. However, since then, there has been little development. Daily turnover is microscopic by global standards[93], block trading accounts for more than 90 percent of turnover, and market capitalization is estimated to approximate 1.1 billion leva, of which half is owned by government and little else is traded. As of mid-2000, there were only 25 companies trading on the official BSE exchange, of which two were banks[94]. The government securities market has worked well, with an efficient and accurate auction process. However, because of low rates and the absence of open market operations, this has deprived banks and others of a more active market. More recently, the Securities Commission's term lapsed, and it took four months for replacements. That terms are not staggered represents a fatal flaw. The weakness of data and information and low transparency of off-market trading have prevented Bulgaria's markets from developing in a manner that instills confidence and is effective in mobilizing capital.

[93] For example, daily turnover averaged 592,000 leva (less than $300,000) in February 2001.
[94] Cooperative Credit Bank and BRI Bank (since renamed).

- **There is growing insurance sector activity, but the sector remains underdeveloped and subject to abuse**. Penetration rates are low, at about 2 percent of GDP. Gross premium revenues were nearly 350 million leva in 1999, with most of it in non-life products. There are reported to be many problems with the existing insurance framework[95], including weak supervisory capacity, frequent regulatory changes, tax disincentives, poor financial information and corporate governance standards, and numerous opportunities to undermine policyholder (consumer) protection. To prevent abuse and promote growth of the sector, the regulatory authorities have reportedly been "control-oriented" rather than establishing a medium-term framework for the evolution of a more market-based risk-focused system. While it is premature for many reasons to assume adoption of a risk-based approach to supervision can be achieved overnight, it is feasible to develop a framework by which the supervisory authority can establish the requisite procedures, obtain the needed information (on transactions, contracting parties, and market as a whole), and develop the risk monitoring and classification system to ensure a stable insurance market. At a minimum, this will require (i) smoothing out legal/regulatory issues and tax incentives to foster sound development of the insurance market; (ii) better, timelier and more accurate information within companies as well as to the regulators to detect risks and potential problems early on; (iii) professionalized standards of corporate governance and better management practices, supported by improved systems and technologies; and (iv) general improvement in standards of consumer protection. To the credit of the supervisory authority, it closed down 85 companies unable to comply with basic standards and financial measures. There were 32 insurance companies operating in early 2001, although many of these were thought to be unable to compete in the long run with some of the companies with large market share (e.g., Bulstrad, State Insurance Institute), or global giants that are getting established in Bulgaria (e.g., Allianz, AIG, Munich Re).

- **Recently adopted pension reforms in 1999-2000 prompted the initial beginnings of movement to a three-pillar pension scheme. As a result, as of early 2001, there were 10 licensed private voluntary pension funds, of which nine appeared to be operating**. There were about 411,000 insured persons in the voluntary pillar at September 30, 2000, of which PIC Allianz Bulgaria was the largest with more than 215,000, or more than half the market. Assets of the voluntary funds were about 75 million leva (about $35 million). This amounts to about 180 leva per insured, relatively small, but a start to what is expected to be an enhancement to individual savings. In terms of companies, Allianz also had about half of assets under management. There was no major deviation of average assets per insured among any of the active voluntary pension funds except the Bulgarian Pension Insurance Company at the high end (445 leva per insured), and PIC Newton-Sila (82 leva per insured) and PIC Saglasie (126 leva per insured) at the low end. Most of the other companies were below the average, but not materially deviating from the norm set by Allianz. In addition to custodial services, several banks are playing the role of investment intermediary. Raiffeissen is investing on behalf of the largest fund (Allianz Bulgaria) as well as the SCPIC Rodina Fund (along with BNP Paribas, ING, and Municipal Bank). Biochim and Municipal are investment intermediaries for the Bulgarian Pension Insurance Company, which has attracted the highest average contribution per insured. ING is also

[95] Information on insurance is derived from meetings and background information. For a comprehensive review of the Bulgarian insurance sector, see "The Insurance Industry and Insurance Supervision in Bulgaria" (draft), Lawrie Savage & Associates Inc., December 29, 2000.

investment intermediary for PIC Solidarity, while ING and UBB are active in this domain with PIC Saglasie. With the expectation that these funds will at least grow modestly in the coming years, banks are expected to play financial support roles (e.g., custodial, investment intermediary) as well as develop retail strategies for companies and households that include pension-related services as one of their features.

- **Bulgaria has a limited degree of leasing, although there are no major legal or regulatory constraints**. Leasing companies are not licensed, although they are required to be registered with BNB as a non-bank financial institution. About 25 companies have done so, although there are others reported to be leasing on a smaller scale. The main problem associated with leasing is the prepayment of equipment for lease, which was made more burdensome due to the six-month wait on VAT refunds. The government is introducing a four-month refund as of 2001, and this is expected to help. However, leasing of large equipment will still be somewhat constrained by most enterprises' financing needs, and the prepayment requirements for much equipment. Banks will be able to help by providing credit and trade finance facilities, as is already happening on a limited basis between some banks and the few leasing companies in Bulgaria. There are also benefits to leasing, which include faster processing, less complex documentation, and unsecured transactions. However, these represent risks to banks should they become over-exposed and lessors run into trouble with lessees defaulting on their contracts.

- **There are no major credit cooperatives in Bulgaria, although some smaller savings cooperatives exist in rural areas**. The closest has been the Central Cooperative Bank, which accounts for only 2 percent of total assets and 1.9 percent of total deposits. However, the bank only had a reported 143,000 leva in earnings in 2000, and is not considered a strong bank. In addition, there have been donor efforts to support development of a credit union movement. However, to date, there has been virtually no impact on financial sector aggregates.

- **Commercial finance and factoring are limited, although some companies are expressing initial interest in these activities**. Commercial finance efforts can be expected to pick up as banks increasingly compete in the SME sector. Factoring market development will occur as investments in electronics come on stream, banks make increasing efforts to syndicate to divest assets and earn fees, as the overall volume of receivables increases in the market (which is inevitable with increasing commitments to retail banking), and as improvements in credit information quality and disclosure materialize so that market players can assess the risk of packages and appropriately price these packages.

IV. BANKING SECTOR DEVELOPMENT BASED ON PRUDENTIAL NORMS

Bulgaria has accomplished a great deal since 1997, not the least of which is stabilization of the banking sector, implementation of an improved prudential regulatory framework with which the banks are able to comply, and a general framework for sustainable growth and development of intermediation capacity that is prudently managed relative to risk assumed. Capital adequacy is high, which reflects substantial extra capacity. Asset quality has improved significantly, with standard loans now 92 percent and loss loans less than 4 percent. Liquidity ratios are high, partly a reflection of banks' limited alternative investment opportunities. Thus, CAL measures are generally strong, notwithstanding adjustments that may occur between preliminary figures issued by BNB and externally audited statements.

However, banks' earnings are not particularly strong, partly because their approaches have been conservative. Even when companies are known to be credit worthy, their inability or unwillingness to comply with underwriting standards has translated into investments in low-return paper and securities, usually in offshore banks, rather than lending to Bulgarian enterprises. This is beginning to change now that competition is heating up. Moreover, banks' 20 percent return on average capital and 3 percent returns on average assets are not bad for a low risk environment. However, given the small base of activity, overall earnings are limited, particularly for many of the smaller banks. Thus, moving forward, banks can be expected to take on more risk in pursuit of higher earnings.

The trend towards greater risk assumption will require adequate risk management systems to be in place. The investment-grade international and regional banks have this capacity. It remains to be seen how much risk other banks will take in the Bulgarian marketplace, and how well they will manage these risks. This will need to be monitored carefully by BSD, as well as by the banks in assessing their exposure to the inter-bank market. This will primarily focus on fundamental credit risks, but also on underlying mismatches or gaps regarding interest rate features, exchange rates, and maturities. This will call into question not only the management capacity of individual banks, but also the efficiency and timeliness of MIS and the ability of individual banks to identify and contain risks early on to prevent adverse effects on portfolio quality and earnings. **Score: 3**

4.1. Capital and Capital Adequacy

Bulgaria's banks are currently "overcapitalized" in terms of CARs, while being relatively small on average in terms of actual capital. CARs at end 2000 were about 36 percent. Even with some adjustments after audited statements, this suggests that banks have excess capital relative to risk-weighted assets. **Now that banks are poised for growth and seeking higher earnings, it is assumed that they will more actively deploy their capital**.

In terms of aggregate capital, **the Bulgarian banking system had about 1.4 billion leva at end 2000, or about $656 million. This averages about $24 million per bank net of foreign bank branches. Thus, the average bank cannot generally make loans in excess of $2.4 million**, which is very small by international standards. **Score: 3**

- **Based on end 2000 figures[96], Bulgarian banks had nearly 1.4 billion leva in capital, or about $656 million**. This is double bank capital figures from end 1997 ($326 million), but virtually unchanged since 1998. Capital figures in dollar terms were identical at end 1999 and 2000, and little changed from end 1998 when bank capital was $597 million. This is actually a poor reflection on the banks' retained earnings, as increases in bank capital have generally come from privatization. This also reflects the small size of most Bulgarian banks based on international norms. Netting out the eight foreign bank branches, average capital is only $24 million per bank[97].

- **Bulgarian bank capital was 35.6 percent of risk-weighted assets at end 2000, reflecting a high system CAR that is well above the 12 percent regulatory requirement**. Year end CAR for the system was higher than at end 1997 (26.9 percent), roughly comparable to end 1998 figures (36.7 percent), and lower than figures in 1999 (nearly 42 percent throughout the year and through March 2000). The high CARs are partly the result of limited risk-taking, as a major share of bank assets is placed in investment-grade paper in foreign banks and government securities whose risk weights are low (generally zero to 20 percent). Primary CARs were 25.1 percent at end 2000, and capital was 15.2 percent of total assets (unadjusted for risk).

- **There is a possibility that CARs are overstated, and this should be corrected through the external audit process**. One of the major distortions that still exists is the improper valuation of assets, particularly assets that would be more properly valued at "fair market value" or marked-to-market were there sufficient market activity. This particularly affects fixed asset valuation. In addition, it is reported that risk weights are not always appropriately applied, particularly with regard to mortgages.

- **The distribution of CARs varied across banks at end 2000**, as the three largest banks (Group I) had CARs of 41.5 percent, and the 16 smaller and more troubled banks (Group IV) had CARs of 52 percent. Meanwhile, the 16 mid-sized banks in Groups II and III had CARs of 27.4 percent and 31.3 percent, respectively, at end 2000. Branches of foreign banks are not required to report their CARs to BNB.

96 Figures are cited from the BNB in "Bulgaria: Selected Issues and Statistical Appendix", IMF, March 2001. These capital figures differ slightly from the 1.5 billion leva figure reported for the banks in "Commercial Banks in Bulgaria," BNB Quarterly Bulletin, December 2000. However, the 1.4 billion leva is consistent with the capital base figures used in BNB CAR calculations.

97 The higher BNB figure would bring average capital to $26.5 million for the 27 banks in Groups I-IV.

4.2. Asset Quality

Based on preliminary year end BNB figures, **the banks' loan portfolios remain satisfactorily provisioned, with most loans standard (92 percent) and loss loans under control (3.4 percent). This represents a major improvement from only 79 percent standard loans at end 1997, of which a substantial portion of the balance were loss loans**. Since then, banks have been very conservative in terms of their lending policies. Loans have been more than fully secured (at least in terms of paper value), and a majority of earning assets have been placed in primarily investment-grade paper in offshore banks. The positive side of this approach has been risk containment. The negative side has been relatively unimpressive earnings, passive approaches to asset management, and foregone opportunities for economic development.

Score: 3

- **Bulgarian banks' asset quality has improved dramatically since end 1997**. At end 2000, 92 percent of bank loans were judged to be performing ("standard"). This compares with 79 percent at end 1997, and 86-87 percent in 1998-99. Moreover, loss loans have decreased significantly since 1997, declining from 13 percent of total to 3.4 percent at end 2000. While loan loss provisions were not available for 1997-98, they came down from 10 percent at end 1999 to 6.5 percent at end 2000.

- **Earning assets were 86 percent of total at end 2000**. This is high, and is an improvement over the 82 percent figure at end 1999.

- **The biggest problems appear to be in bank groups II[98] and IV[99], which showed 15-20 percent of their credit portfolios to be sub-standard**. In the case of Group II banks, the problem has been identified and trends are more favorable. While nearly 11 percent of loans are loss, and provisions were 12.5 percent at end 2000, both of these have been declining since 1999. For example, Group II loans were 38 percent sub-standard as of mid-1999, including 27 percent of total loans classified as loss. Thus, while Group II figures are weak, they are improving. Group IV shows lower levels of loss loans, generally in the 3-5.5 percent range since mid-1999. However, "watch" loans more than doubled in the second half of 2000, and this could portend a future weakening of overall asset quality at many of these banks.

- **Improved asset quality has strengthened bank capital**. Total loss loans at end 2000 approximated $120 million (adjusted for exchange rates), or 18 percent of bank capital. This compares with $276 million at end 1997, or 85 percent of bank capital. Thus, Bulgaria's capital position is much stronger now than in 1997, and this is largely based on the significant improvement in the quality of banks' overall credit portfolios. Even with the Group II banks, credit quality has gradually improved, as shown in the steady reduction of loss loans since 1999. While Group IV banks show some signs of potential deterioration, they account for only 7.4 percent of total banking system assets. Thus, problems in this

[98] Expressbank (now owned by Société Générale), Biochim, Hebros (owned by Regent Pacific), Post Bank (owned by EFG and AIG) and BNP-Paribas.

[99] Neftinvestbank, Bulgarian-American, Eurobank, Unionbank, Corporate Commercial, Demirbank, Tokuda, First East International, International Commercial, Teximbank, Bulgaria-Invest, Promotional, and International Bank for Trade and Development.

group would not be expected to have a material adverse effect on the banking system as a whole.

- **Banks have been criticized for not lending sufficiently to the enterprise sector, and continued pressure could eventually lead to a decline in overall asset quality**. Bank lending to the real sector was 12.5 percent of GDP at end 2000, and totaled $1.4 billion. With credit-to-GDP more commonly in the 20-35 percent range in most EU accession candidate countries, there will likely be pressure on banks to lend more. This will be particularly fervent with regard to medium- and long-term loans, loans to SMEs, and loans for household purchases of consumer goods. If there is a material change in loan volume, this could reduce banks' asset quality. For now, with capital adequacy ratios of about 36 percent, there is cushion with the banks to absorb losses. Likewise, there are expectations that more experienced foreign banks have better management systems and will be able to manage associated risks. Nonetheless, it can also be expected that increases in loan volume and/or a shift out of safer investments in bank paper and government securities will bring with it greater risk of sub-standard loans than is currently reported.

- **The risk of declining asset quality would be particularly true if there were political pressure to lend to troubled state enterprises**. Net losses in the state enterprise sector approximated $250 million in 1999, and banks have steadily reduced their exposure to these companies since 1997. To date, there has been no discernable pressure from government to have the banks bail out these enterprises. However, with unemployment rates at 18 percent, there could be some political pressure to assist troubled state enterprises, particularly if this is part of any deal-making for ongoing support for the new government.

- **In general, financial intermediation has been hampered by weaknesses in the enterprise and household sectors**. In the enterprise sector, many of the potentially larger loans would be made for longer maturities, with questionable collateral, and dubious prospects for enforcement in the event of default. Poor governance, a prevalence of insider dealings, unreformed management and unrestructured companies all represent poor targets for bank loans. Among SMEs, there are likely to be strong candidates for bank borrowings. However, for the banks, there is an issue of incentives with regard to credit risk evaluation, the lack of a documented credit history for many of these firms, and the same judicial issues with regard to secured transactions should a debtor default. As long as banks can generate relatively easy earnings from securities and paper, they are likely to do so. This avoids the added cost of loan evaluation and processing, avoids the risk of loan losses, and facilitates compliance with prudential norms. Meanwhile, households make small loan requests that are rarely economically justified from an administrative cost point of view. There has also been a tendency to expect the banks to provide a disproportionate share of overall financing, when increased equity (for improved capital structure) and other kinds of debt provided by other kinds of financial institutions (e.g., commercial finance, factoring, consumer credit, leasing) might be more appropriate in these cases. While the banks themselves deserve some of the criticism that has been lodged, most of the problems involve weaknesses of the business sector, problems in the general business environment, the dearth of attractive projects, and limited non-bank financing options.

- **Bulgaria's regulations address large exposures, connected/related party/insider**

lending, non-performing loans, interest accruals, provisioning, and exposure limits. These are all basically consistent with Basle and EU guidelines. For example, large loans represent anything greater than 10 percent of bank capital, and are defined as exposure to a single client—thus, large "loans" go beyond credit, and are treated on an individual and on a consolidated basis. Total exposure of the bank to a single client cannot exceed 25 percent of bank capital. Total large exposures to all single clients cannot exceed 800 percent of bank capital. There are some exemptions from large loan definitions—exposure to government or government guarantees, the BNB, IFIs, other central banks approved by BNB, and securities or other exposures with 110-125 percent guarantees. However, by and large, the prudential requirements and definitions are consistent with international standards.

- **The regulatory framework introduced in 1997 provided for favorable tax treatment for loan loss provisioning**. This was introduced as part of the larger effort to introduce standards consistent with international best practices, and to provide an incentive to banks to classify and provision problem loans in a timely manner. This approach appears to have succeeded, as shown in the general decline of classified loans since 1997, and the increase in provisioning expenses in 2000 despite a decrease in corporate tax rates[100].

4.3. Management

There have been improvements in management due to the strengthened incentive structure introduced into the banking system in 1997-98. However, because banks have still not moved forward aggressively in assuming more risk, **it is too early to evaluate how adequate systems are, and how much better prepared management teams are to identify and contain problems when they emerge**. It is expected that the major foreign banks will be able to handle these problems based on their experience from abroad. However, there are questions about the ability of Group IV banks in particular to manage these risks.

Beyond that, there are also fundamental organizational issues related to efficiency and the management of cost structures. In general, banks have high costs, and their net earnings are largely based on low rates of interest paid on deposits. Market competition will test these banks' capacity to adapt to more active management of risks and costs. **Score: 3**

- **While the last few years have been focused on stabilization of the banking system, the next chapter will involve greater competition and risk-taking. This will put the onus on management to implement effective risk management systems while seeking to increase earnings from an augmentation of risk-taking activities**. Fundamental risks will include credit management—introducing sound underwriting standards, monitoring of borrower compliance with loan covenants, ensuring adequate reporting standards, and collecting on loans or collateral. It is expected that banks will increasingly move into retail/consumer banking now that net spreads in the corporate market have shrunk. Consumer lending frequently carries with it higher-than-average rates of nonperformance, and is heavily dependent on credit information services for individuals and companies. Thus, banks will have to be more active in credit risk evaluation, and managing credit risks once exposures are booked. There has been some interest in mortgage lending, which is long-term by nature and heavily dependent on a legal and market structure that enforces

100 Lower tax rates reduce the attractiveness of provisioning.

contracts. More can be expected as judicial reform is implemented in a creditor-friendly manner and on a timelier basis. The temptation to invest in real estate as a mortgage finance market develops will likewise carry with it the risk of asset bubbles. All lending will need to assess the rationality of assigned values for pledged assets and collateral.

- **Incomplete risk management systems and management that is sometimes untrained in more complex risks than Bulgaria has faced in recent years could lead to some volatility that the market has not experienced since 1997**. Many banks currently do not appear to have adequate MIS for efficient management. Part of this is rooted in the IT problem that is currently being addressed by several banks. However, the absence of state-of-the-art systems will impede banking sector development and raise risks about the underlying quality of risk management systems. This could perpetuate some of the risk aversion that has been evident in the last few years at a time when earnings are adequate but not outstanding. Alternatively, increasing risk taking may lead to some adverse selection, with potential problems deepening as a result of the limits of existing risk management systems. These problems are compounded by underdeveloped internal audit functions, although this is being addressed by banks by luring supervisors from the BNB. In general, it will be necessary to ensure that banks and their risk management systems can account for the maturity, pricing, and currency issues from a portfolio standpoint, as well as the underlying quality of each asset.

- **Foreign banks should not be viewed as immediate panaceas to solve banks' or banking system weaknesses**. While the presence of large foreign banks is a welcome development that should enhance banking sector competitiveness in Bulgaria, it also takes time for foreign managers to adapt to new markets. Likewise, it takes time to shape or re-shape bank organizational structures and internal cultures. Thus, while foreign investment into the banking sector is a positive development, there should be no expectation that this will automatically translate into major increases in funding mobilization or lending. It is more likely that there will be an overall increase in deposit mobilization, lending, and commission/fee-based products and services over the next few years, but that it will take three to five years before the vast majority of households are directly linked to the banking system for more than just simple safekeeping purposes.

4.4. Earnings

Banks have shown positive earnings since 1997, although in 1997, this was due to translation adjustments. **Since 1998, earnings have been relatively meager due to low levels of risk assumption on the asset side. Margins have been made less on cost effectiveness or new efficiencies, and more on the basis of negative real rates paid on deposits**. Banks have generally not yet built up a diversified stream of non-interest earnings, although Bulbank appears to still generate reasonable returns on trade-related services. Apart from this, the earnings stream has been adequate—ROE and ROA were 20 percent and 3 percent, respectively, in 2000—but the mass of earning assets is not yet large enough for total income to be of any particular significance. **For 2000, average net earnings per bank were less than $4 million. Even if fully retained, this is no enough for the kinds of investments and systems needed for modern banking**. **Score: 3-**

- **Bank earnings in 2000 were net 283 million leva, or $133 million**[101]. This compares with 207 million leva, or $113 million in 1999. These net income figures translate into 20.3 percent return on capital (including reserves[102]) and 3.1 percent return on assets. Both measures are respectable, but they are not sufficient to generate the earnings needed for major expansion of banking assets. Rather, the earnings stream reflects safe investments and a cautious approach to risk, which is consistent with the incentives of the prudential framework.

- **Total income in 2000 was mainly derived from interest-earning assets, followed by trading activities, and then from other unspecified non-interest income**. Interest revenues were 601 million leva, or $283 million, mostly on loans to the real sector (368 million leva/$173 million), followed by interest earnings on foreign currency placements with banks and other financial institutions (193 million leva/$91 million), and an additional amount from securities investments (40 million leva/$19 million). These figures indicate that lending is more profitable than interest earned from non-lending activities. Interest revenues on lending approximated 13.5 percent of average loan assets[103], as opposed to 5.9 percent on claims on banks and other financial institutions[104] and 7.4 percent on securities investments[105]. Thus, when banks move forward to boost earnings more aggressively, this is expected to be partly based on a shift to lending. Earnings from trading and revaluation were 332 million leva, or $157 million. This amounted to a 32.7 percent return on average securities in the trading portfolio, by far the most profitable activity among the major sources of earnings for the banks in 2000. Other non-interest earnings were 190 million leva ($90 million).

- **There are some variations in the activities of different bank groups and their earnings sources**. The three largest banks in Group I[106] together accounted for 49 percent of interest revenue, 73 percent of trading and revaluation earnings, and 41 percent of other income. Given the efficiency of earnings from the second category, this suggests that the Group I banks should have a higher proportion of overall net earnings, which they did at 84 percent of banking system net income. This is favorable on a comparative basis, as these banks have about half of total system assets. In contrast, Groups II-IV reported very low net profits, and branches of foreign banks posted minor net losses. Group II banks[107] generated more than half of earnings from interest revenues, but only 20 percent from trading and revaluation. Group III[108] and Group IV banks[109] each relied on interest revenues for two

[101] Average exchange rates of 1.84 (1999) and 2.12 (2000) leva to $1 are used for income figures.
[102] Excluding reserves, return on equity would be 28.3 percent.
[103] Interest revenue from the real sector in 2000/(average loan assets at year end 1999 and 2000).
[104] Interest revenue from the financial sector in 2000/(average due from banks and other financial institutions at year end 1999 and 2000).
[105] Income on investment securities in 2000/(average securities in investment portfolio at year end 1999 and 2000).
[106] Bulbank, UBB and DSK.
[107] Bulgarian Post, Biochem, SG Expressbank, Hebros, and BNP-Paribas.
[108] Raiffeisen, First Investment, Central Cooperative, Economic and Investment, Rossexim, and Municipal.
[109] Neftinvestbank, Bulgarian-American, Eurobank, Unionbank, Corporate Commercial, Demirbank, Tokuda, First East International, International Commercial, Teximbank, Bulgaria-Invest, Promotional, and International Bank for Trade and Development.

thirds of their total earnings, while branches of foreign banks[110] (Group V) relied on interest revenues for three quarters of total income. In the last case as well as with some of the other international banks, trading may be de-emphasized in Bulgaria because of the limited market, and because they have more units abroad that handle these kinds of activities. However, it also suggests that the smaller domestic banks are able to generate only very limited earnings from trading and other non-interest activities. Given relatively small balance sheets (Group II-IV banks averaged only $82 million in total assets[111] at end 2000) and low levels of lending, these banks are likely to have to develop new earnings sources (e.g., trading, fee/commission, custodial, advisory) and/or increase lending over time to generate needed earnings for growth and viability. Otherwise, they risk being marginalized by the more efficient Group I banks and foreign banks.

- **Total expenditure was primarily from operations, followed by interest paid on deposits, taxes, and provisions for loan losses**. <u>Overhead</u> was the biggest expense, at 469 million leva ($221 million), about 55 percent of total. This is high and can likely be brought down with more efficient use of technologies as a substitute for high personnel levels. There were 21,000 employed in the banking sector at end 2000, or 600 per bank. Given the earnings and balance sheets of most banks, their financial performance would likely improve with a shift to more advanced methods of processing, and the reduced compensation that comes with high head count levels. Because banks pay low rates on deposits, <u>interest expense</u> was only 187 million leva ($88 million), or an average 2.8 percent. While this keeps the banks' funding costs down and generates high net interest margins, it also very likely explains part (but not all) of the reason why aggregate deposits are relatively low[112]. The low rates also reflect the predominance of deposits in short-term instruments of less than one year. <u>Taxes paid</u> were 135 million leva[113] ($64 million), equivalent to 1.75 percent of government tax revenue for 2000 and 0.5 percent of GDP. <u>Provisions for loan losses</u>, which are pre-tax items to provide banks with an incentive to recognize potential losses in a timely fashion, were 65 million leva ($31 million), up from 10 million in 1999.

- **In general, cost-to-income ratios are good, but this is based on low levels of interest payments on deposits rather than operational efficiency**. Cost-to-income was 75.1 percent in 2000, which is sound. This translates into a net margin of nearly 25 percent, which would provide the banks with strong earnings if they had larger volume. As noted earlier, net loan-to-deposit spreads are about 9-10 percent. Combined with safe investments in banks abroad and government securities in Bulgaria, the earnings stream has been fundamentally sound. However, with total net earnings of only $133 million, this means the average bank in Bulgaria only generated an average $3.8 million in 2000. This is not enough to make needed investments in advanced technologies and personnel training for modern banking, let alone for major increases in lending and investment. Meanwhile, in terms of long-term sustainability, net interest income was less than overall operating

---

110 ING, Hypovereinsbank, Société Générale (as of end 2000), Xiosbank, NBG, Ziraat, Alpha, and Citibank.

111 4,155,387,000 leva in assets. Leva-to-$ exchange rate at end 2000 = 2.1. Therefore, total assets of Group II-IV banks = $1,978,755,714. Group II-IV = 24 banks, therefore $82,448,155 in assets on average.

112 At end 2000, total deposits were 7.1 billion leva, or $3.4 billion. This is $408 per capita.

113 This is higher than the 97 million leva figure reported by general government as profit tax revenue from financial enterprises.

expenditure. This is not sustainable, and should trigger additional efforts by banks to improve operational efficiency.

- **Interest rates on loans and deposits are not subject to price controls, nor are other fees. However, the laws do stipulate that banks need to be open and transparent with clients about their pricing on deposits, loans and services**. In 1997, Bulgarian banks generally lacked pricing strategies for services, both relative to risk and as a function of marketing strategy. More experienced foreign banks did have pricing strategies in place. As most of the major domestic banks have been privatized with strategic investment from abroad over the last three years, it is expected that banks will begin to provide more non-lending services to the corporate sector and, eventually, to the consumer sector. Several banks have already costed out services and can now provide detailed pricing for a growing array of services.

- **There was little evidence of mandated lending in 1997, and this was restricted to the agricultural sector, mainly in the form of guarantees and subsidies for the wheat sector**. Since 1997, subsidies have declined even further as a percentage of GDP and budgetary expenditure. Where there have been distortions are with regard to household subsidization of electricity prices, and general arrears in commercially non-viable (and largely state-owned) enterprises. However, the previous government steadily imposed hard budget constraints. Consequently, there is no serious level of government-mandated lending, and that which is made appears to be openly disclosed.

- **Tax rates are not exceedingly high for banks, and they are coming down**. Banks' pre-tax income was 417 million leva, and after-tax income was 283 million leva. This constitutes an effective profit tax rate of 32.3 percent. With tax rates coming down another 5 percent in 2001, the tax burden should diminish, providing more funds for needed investments in risk management and information systems, training, and other needs.

4.5. Liquidity

Bank liquidity ratios are high, partly reflecting regulatory requirements and partly reflecting risk aversion on the part of the banks. This is apparent in the pattern of asset management since reserve requirements were reduced from 11 percent to 8 percent. In most markets where intermediation rates are low, banks would have used the differential for lending to generate higher earnings. However, banks generally placed most of these funds in the same low-risk offshore bank paper that had been the destination of most of its other earning assets. Banks have followed this approach for several reasons, all of which are prudent. First, loans need to be more than fully collateralized, otherwise banks need to provision against the unsecured portion or the loan as a whole. Second, there is clear risk associated with lending in Bulgaria. Third, it is administratively cheaper for banks to simply place funds in offshore bank paper, rather than undertaking the hard work involved in underwriting credit risk. Fourth, offshore bank paper is readily marketable. Finally, it is easier for banks to comply with regulatory requirements. Thus, banks have been prudent to maintain high liquidity ratios.

The downside to all of this has been the relatively low returns banks have earned as a result of these approaches. Now that margins have begun to shrink in the corporate lending market, and because there is little government securities market from which to generate safe returns, many banks are now looking to take on more risk. This should bring liquidity ratios down, yet lead to higher earnings. Given the low aggregate earnings of the system in 2000, these kinds of developments are inevitable in developing a modern banking system. However, **banks and regulators will need to continue to monitor fundamental interest rate, exchange rate, pricing and maturity gaps to ensure that individual banks do not push the limits and endanger their ability to honor deposit withdrawals, guarantees, and other transaction requirements**. For the foreseeable future, this is not expected to be a problem. It is also expected that movement to RTGS will help banks with their liquidity management practices. **Score: 3**

- **Year end 2000 liquidity ratios were high, although generally much lower than ratios reported since 1997**. Primary liquidity[114] for the banking system was 10.4 percent at end 2000, equivalent to about $350 million. Secondary liquidity[115] was 26.0 percent, equivalent to about $880 million. These high ratios are partly driven by BNB regulations. The ratios also reflect the risk aversion of banks, as they are able to generate easy earnings from investments in safe securities without the added costs and risks associated with lending and other higher return activities (when properly managed).

- **The three largest banks had lower liquidity ratios than the other banks apart from foreign bank branches**. Group I banks had primary and secondary liquidity ratios of 9.0 and 21.9 percent, respectively. This is due to high levels of Bulbank ZUNK bond holdings, and restrictions placed on DSK (the former state savings banks) due to its prominent role in the local currency deposit market. Apart from foreign bank branches, the other groups generally showed primary liquidity at 10-16 percent of deposits, and secondary liquidity at 28-40 percent of deposits.

- **Deposit levels were still relatively low in the aggregate at end 2000, although they still constitute a respectable share of broad money when compared with many other transition economies**. The relatively low level of bank deposits is largely due to low incomes and cash needs for transactions on the part of most households. However, banks have also been less than energetic about seeking to mobilize deposits. They have paid low nominal rates on deposits, which have been negative in real terms. While this keeps banks' funding costs down and generates high net interest margins, it also dissuades households and enterprises from placing their funds with banks. Tax avoidance also serves as another incentive to keep funds outside of banks. Notwithstanding these impediments, about 75 percent of total broad money is actually held with the banks.

- **The main weakness of banks' funding structures in 1997 was the lack of confidence people and small businesses had in the banking system**, which meant that funding was relatively scarce for most banks[116]. Total deposits at end 1997 were about $3 billion. **However, confidence has been largely restored with the CBA and a strict prudential framework**. Moreover, when banks have failed, the deposit insurance fund has made deposit payments quickly, thus preventing a further dissipation of confidence in the system. As of end 2000, deposits stood at nearly $3.4 million, a net increase of $415

[114] This is cash, gems and other immediately liquid assets as a percent of total deposits.

[115] This is all liquid assets (e.g., cash, short-term marketable securities) as a percent of total deposits.

[116] There was a high degree of concentration of deposits in 1997—corporate foreign currency deposits placed with Bulbank, and domestic retail deposits placed with State Savings Bank (now DSK), and to a lesser degree, with Postbank. As a result, most other banks needed to go to the inter-bank market or other sources to borrow if they wanted to lend or invest.

million over the three years. However, concentration remains a problem, as the Group I banks still control 51 percent of total deposits, and Group II banks have 24 percent. Thus, the remaining 27 banks have only 25 percent of total system deposits, making them dependent on inter-bank or outside sources for intermediation purposes. For the foreign banks this is generally not a problem. However, for the smaller domestic banks, it is.

- **Problems of liquidity management could emerge as a result of fragmented intra-bank and inter-bank reporting, and less than adequate management information systems**. In the former case, this should be corrected with movement towards RTGS as part of overall payment systems modernization, planned to be operational by end 2001. Meanwhile, intra-bank and MIS problems relate to fragmentation of systems and reporting. Inter-branch transfers can occur without other branches or headquarters being aware at the time of the transaction. Meanwhile, more targeted and timely management reporting needs to emerge from the voluminous data that run through bank systems.

- **Since late 1997, bank managers have managed fundamental sensitivities to pricing, interest rate, and exchange rate movements according to prudential regulations**, which require better liquidity management and reporting on a cash flow basis[117]. However, more accurate, timely and targeted information would help make liquidity management more efficient. The stable environment since 1997 may be obscuring some underlying weaknesses in capacity and liquidity management practices.

- **Reserve requirements recently declined from 11 percent to 8 percent of total deposits in July 2000**. There has been no evidence of non-compliance among the major banks since the currency board was introduced. The government/BNB was contemplating a further reduction of reserve requirements, but they are now on record as being opposed to a further reduction[118]. This is to provide a reserve while fiscal policy is loosened with tax cuts, and because the incremental assets were placed in securities with banks abroad rather than in new lending. Thus, a reduction in reserve requirements would help bank earnings, but would do little to increase lending. Thus, the potential costs to macroeconomic stability of further monetary loosening exceed the potential benefits to the economy at large.

- **Loan-to-deposit ratios were a low 42 percent at end 2000**. This is very conservative, but higher than the 40 percent figure at the end of 1999. Generally, lending has declined or been kept at low levels for several years, and most asset activity is in the form of investments in investment-grade paper abroad and government securities. These holdings were 76 percent of deposits at end 2000. Meanwhile, deposits are the main source of funding for the banks (86 percent of total liabilities at end 2000) as banks cannot borrow from BNB except under strict conditions that apply to central bank refinancing of commercial banks.

- **Asset-liability management practices have adjusted to regulatory requirements and**

[117] By definition, this requires banks to think about the parameters of their cash needs in the coming week, month, quarter and six months. Such calculations have to account for possible movements, and the positions taken to hedge against movements that would imperil liquidity requirements.

[118] See "Letter of Intent and Memorandum of Economic Policies of the Government of Bulgaria", Article IV Consultation, IMF, March 2001.

have basically kept up with fundamental market conditions. At end 1997, there was still some evidence of major mismatches by maturity—positions that were essentially short on the liability side and long on the asset side. However, that does not appear to be a problem any longer for the system as a whole, although some banks are reported to still have mismatches. In general, banks have been using maturity tables for the maintenance of liquidity reserves over the last several years. Banks are generally long in all maturity categories, although there is only a limited gap in the six- to 12-month range. Group III banks and foreign bank branches are the exceptions, although Group III banks have high primary and secondary liquidity ratios and Group V banks should have adequate resource cover from abroad[119].

- **Regulations putting in place restrictions on foreign exchange exposure have been adhered to**. At end 2000, banks (except for Group IV) actually had negative open foreign currency positions, with the banking system's figures at negative 4.34 percent of capital.

4.6. Operating and Regulatory Environment

The operating and regulatory environment has improved in Bulgaria since 1997. **Laws and regulations largely conform to Basle and EU standards, and banking supervision has asserted itself with general enforcement of its mandate**.

Accounting standards are evolving increasingly towards IAS. External auditors have been used not only for annual audits, but also to point out improvements needed at banks with regard to MIS, IT, internal audit, and other building blocks of a modern banking system.

Deposit insurance is now in place, and an active fund supported by mandatory bank contributions has been established with borrowing authority to provide reasonable coverage. While insufficiently capitalized to date, this has to do with the relatively recent introduction of the deposit insurance fund. Two banks have been closed and deposit payouts orchestrated within 45 days. There was no public panic, suggesting that households and enterprises with deposits feel relatively confident their deposits are safe.

The government curtailed bank refinancing with the CBA, and **the lender of last resort function is limited to secured lines for liquidity support to viable banks that have run into short-term liquidity problems**. There has been no reported use of this function since the CBA was introduced in mid-1997.

Concentration has diminished as the market has opened up to competition. Bulbank and DSK retain strong positions in traditional activities. However, balance sheet indicators show a reduced level of concentration. Meanwhile, Bulbank has been privatized, and DSK has been required to operate under restricted lending conditions. Meanwhile, DSK also had its state guarantee on deposits removed as a condition of its ongoing right to operate. **Score: 3**

- **The introduction of a revised deposit insurance scheme in 1998 helped to restore confidence[120]. However, the CBA is the main source of confidence for depositors**. The

---

119 Among the Group V banks, five of eight are among the largest in the world.

120 In light of the banking crisis and economic collapse faced in 1996-early 1997, the government backdated an amendment to the deposit insurance law that limited coverage and put payments on a two-year schedule. This reflected limited public resources to make good on payments. The consequence was a major loss of confidence in the banking sector and, specifically, the safety of deposits. This triggered a major flow of resources out of the banking system.

revised deposit insurance legislation is mandatory for all deposit-taking institutions, and provides for borrowing options along with increases in premiums under emergency circumstances. There are also conservative investment principles to ensure that assets are not mismanaged. To date, two banks have been closed with deposit payouts made within 45 days. There has been no panic when these events occurred. Thus, it appears that the deposit scheme is making a contribution to the restoration of confidence. However, the incomplete bank resolution framework that exists in Bulgaria raises questions about how effective and timely these issues can be resolved in the event of a major failure. Moreover, most deposits held with the banks are still short-term, and about half are in foreign currency. Thus, real confidence in the economy and banks will be demonstrated when households and enterprises maintain longer-term instruments. This has been partly stifled by the banks' negative real rates paid on deposits, banks' limited need for funding in light of narrow investment and lending opportunities (that can be justified according to their return criteria and underwriting standards), and household/enterprise propensity for cash transactions.

- **There is a very narrow lender of last resort function in the banking laws, but this is to be used only under tight liquidity conditions of viable banks. Meanwhile, the provisions do not apply to government, as the CBA is not permitted to lend to the government**. The laws provide for fully secured lender-of-last-resort financing for up to three months for solvent banks that face interim liquidity needs. This has not been used since the CBA was introduced. Nonetheless, the previous practice of refinancing banks irrespective of losses has been stopped. This amounts to a full reversal of the earlier and ongoing policy of providing resources for bank rescues on a continuous basis through the active use of lender of last resort financing[121]. BNB is also not permitted to lend to the state, or to state institutions. Thus, for going concerns, the CBA has been effective at introducing a high level of financial discipline.

- **While there is still concentration in the system, this has diminished. Bulbank and DSK were the two key sources of concentration in 1997-98, but this is less the case in 2001. Meanwhile, the banking market is beginning to become more competitive, including at the retail level**. On the asset side, Bulbank retains a sizable position in the corporate market, but this is now being aggressively challenged by several banks, among them the privatized banks and branches of foreign banks. If Bulbank's financial returns indicate a still dominant market position, it is in some of the commission-based activities that emanate from its traditional role as corporate lender. Over time, this is expected to diminish in concentrated market share. Meanwhile, Bulbank may have problems associated with some of the companies in which its ZUNK bonds were used to buy into companies[122]. However, its capital levels, liquidity ratios, and loan classification figures (based on preliminary unaudited figures from BNB) suggest that these problems are under control. What is not known is whether forbearance has been applied in any way due to the bank's importance in the market. That UniCredito bought the bank for E360 million implies that its loan portfolio and related asset holdings were not considered problematic in

[121] In fact, discipline was so weak in the mid-1990s that BNB practices were not tantamount to a last resort at all.

[122] As ZUNK bonds can be used to defray up to 50 percent of the total cost of privatizing a company, Bulbank's large holdings of these bonds may well have been used to own/control some of the enterprises that have been privatized, including indirect control of some MEBOs.

late 2000 when the acquisition was made. Subsequent purchases of equity from SIMEST (the Italian government export bank) and the IFC suggest that their due diligence likewise came up with comparable findings as of early 2001. DSK's dominant position in the retail deposit market has declined. While still high, it now has about 32 percent of the local currency deposit market, down from 50-60 percent in 1997. The bank's weaknesses make it highly unlikely it would be in a position to distort competition, particularly as many banks are now investing in new systems to implement retail strategies. The removal of the former State Savings Bank's state guarantee for deposits has also triggered the need for DSK to adapt to commercial banking practices. At the same time, loan limits on the bank are relatively small[123], narrowing the probability that asset mismanagement could create a major problem for deposit safety or inter-bank funding. It is unclear if the position of the bank in the local currency market has been used to cross-subsidize weaker banks with strong political connections. However, as of early 2001, bankers did not mention this as a problem. Thus, it does not appear that DSK's remaining position in the local currency deposit market has been a problem for banks[124].

- **Banking supervision has improved significantly since 1997, although continued improvement is required to adjust to risk-oriented challenges that will emerge in the coming years**. The regulatory environment was reinforced in 1997 with the introduction of tough banking laws and associated regulations. The last three to four years have seen additional legislation and amendments, new implementing regulations, and development of the on-site examination process. With regard to the latter, capacity has gotten to the point where on-site examinations are effective relative to the levels of risk currently assumed by the banking system, which are low. Thus, further development of this function is required as banks are expected to assume greater risks in the coming years. Meanwhile, off-site surveillance has been slower to develop, partly due to a lack of synchronization of donors providing the financing and personnel for various types of BSD technical assistance. Weaknesses in off-site surveillance include problems with regard to data flows from banks to BSD (including manual processing that is subject to human error), reporting formats, banks' IT systems and MIS that are not yet fully harmonized with BNB requirements, and the under-development of BNB's early warning system. Progress is being made to narrow the gap, and there have been recent examples of where the off-site department has transferred information to the on-site inspection department, triggering targeted examinations. This reflects enhanced capacity, as well as progress in the coordination of strategy between off-site and on-site departments. This, there are clearly favorable developments with regard to the effectiveness of banking supervision. However, more improvement will be required for BSD to play an effective supervisory role as banks assume more risk. Some of the critical needs for enhanced effectiveness include increased and ongoing training, a coordinated HR plan to retain skilled staff, improved quality of data presentation and reporting from banks, and continued coordination between off-site and on-site departments for early detection of problems and risk mitigation.

- **Accounting and audit capacity are still considered major weaknesses, and this creates problems at the source in terms of information quality**. Effective in 1997, state banks were required to produce IAS statements with the help of external auditors in preparation

[123] The maximum loan the bank can make is about $15,000-equivalent.

[124] This may be partly due to banks' general lack of need for funding, although there is demand for local currency funding for domestic payment needs.

for privatization. Since then, domestic banks in general have slowly moved in this direction, while foreign banks already were used to these requirements. The challenge to the audit firms has been to get at the critical information in institutions where the culture has traditionally been tightly guarded, disclosure has been incomplete, and international standards are new. However, this is beginning to change, as banks and others begin to appreciate the need for better information, and the importance of transparency in the functioning of markets. The gap between provisioning requirements of the preliminary statements submitted to BNB by the banks and the externally audited statements indicates that internal bank capacity is improving, and that information quality should likewise be improving for more effective functioning of banks. However, many of the banks are rotating their auditors year to year, which makes it more difficult for auditors to get the kind of understanding they need for effective audits to be conducted. Meanwhile, there has been substantial criticism of the audit profession at large (particularly since 1997 with problems in East Asia and other "emerging" markets), as with the rating agencies, although this should be showing up as an improvement in the quality of audits in Bulgaria and elsewhere. Bankers and others continue to believe there are still significant weaknesses in the audit profession, not the least of which is the limited number of Bulgarian accounting professionals chartered in IAS/ISA and other critical functions (e.g., valuation).

4.7. Transparency and Disclosure

The laws on the BNB and banks introduced in 1997 reflected a commitment to greater transparency and disclosure in the marketplace. Nonetheless, practices had not yet been reformed. By contrast, **there is a great deal more transparency and disclosure as of early 2001**. BNB and most banks have active web sites. New accounting standards, more open financial media, and a general opening of the market have helped to increase information flows.

Notwithstanding progress, pockets of weakness continue to exist. The BNB credit registry does not provide public information on borrowers, nor are there publicly disclosed ratings of banks apart from the rare ratings established by international rating agencies. The sluggish development of the capital markets has also undermined the push for greater transparency and market activity. **Score: 3**

- **Conditions have become far more transparent since 1997. This has been true in most endeavors, including monetary and fiscal policy, banking supervision, and banking**. Legislation calls for banks to produce consolidated statements, even though banks have limited non-bank activity. Reporting on loan losses and non-performing loans has been openly and regularly presented, along with provisions for these losses. Web sites are available from BNB and about half the banks, and these are generally of much higher quality than other web sites provided by government or enterprises. With regard to accounting and methods of valuation, the banks are moving to more mark-to-market accounting, and standards are tightening in the determination of "fair market value" where market activity is limited. There is no question that information is more available on a timelier basis than it was in 1997, and that the quality of the information is better (notwithstanding ongoing problems). However, there are still a number of problems that impede the prevalence of more transparent conditions. These include weak IT and MIS, still weak internal controls and internal audit capacity, and the general underdevelopment of the capital markets. There are also reported to be problems associated with basic communications strategies across a number of public and private institutions, all of which also undermine the effectiveness of more organized disclosure. Examples of this problem include notification of regulatory changes and reporting requirements, and reportedly fragmented information flows between the ACB and the banks. However, overall, there has been a marked improvement in Bulgaria with regard to the transparency of information.

- **The BNB credit information system appears to be helpful, but far from sufficient for banks in gathering needed information for credit risk evaluation**. Bankers appear to use the system as one of many tools for their credit risk assessment. For new customers, bankers still rely on character assessments in determining exposure levels. These character assessments are largely conducted via private conversations and other forms of market intelligence gathering. BNB's system applies to loans in excess of 10,000 leva, and is fairly strict in terms of what it reveals. There is still significant concern about violations of confidentiality, a problem faced throughout the region in the development of more open disclosure on borrowers and their credit histories.

- **The limited development of the capital markets and potential role for institutional investors to play in bank governance undermines transparency**. Banks in Bulgaria appear to be run in a more closely-held manner than banks that are more subject to market scrutiny. Unlike other regional markets, there is virtually no share trading activity of local banks on the local exchange, nor are institutional investors sufficiently developed to play an effective governance role. In fact, only two banks were listed on the BSE in mid-2000, neither of them a major bank. This has impeded the development market infrastructure, share trading, and general market development. Bulgaria's current level of transparency is both cause and effect of underdeveloped markets. However, on a more positive note, conditions have improved since 1997, and trends are increasingly favorable. Development of the contractual savings market, a more organized push to develop capital markets, and the attraction of several large banks and insurance companies into the market all point to increasing levels of transparency in the coming years for market development.

4.8. Sensitivity to Market Risk

Conditions have stabilized in Bulgaria since 1997, as demonstrated by improved portfolio quality, system earnings, nearly complete bank privatization, improved standards of governance and management, better control over mismatches, and Bulgaria's resilience in the face of economic, financial and political crises that have impacted various regional and neighboring markets. **This is a major accomplishment, considering that the country's economy was in a state of collapse at the end of 1996-early 1997**.

Moving forward, it can be expected that **the Bulgarian banking market will encounter greater volatility as a result of increased competition**. This will result in increased earnings and lending, a diversification of products and services, the introduction of more complex services that generate fees and commissions, and consolidation from 35 banks to a smaller number. However, along the way, there are likely to be periodic losses or portfolio erosion that can spread to other banks and the system at large. This may be through the inter-bank market, as a result of certain alliances across financial services, or simply due to reputation and the concern the public may have on fundamentals such as deposit safety.

It is likely that most of the risks banks face in the next few years will be basic to

banking—credit, interest rate, exchange rate, pricing, maturity. It will be necessary for banks to ensure they have adequate systems in place for credit risk evaluation and continuous loan monitoring. Being aware of who has controlling interests in borrowing companies will be essential in preventing serious losses from occuring. A strengthening of the enforcement of creditors' rights through the court system will be needed. Likewise, when a bank fails, a more developed resolution framework will need to be in place for orderly liquidation. However, Bulgaria is not currently burdened with high levels of risky derivatives trading, excess guarantees, or over-exposed trade financing arrangements. Likewise, while banks are beginning to move into non-bank activities like insurance and private pension funds, these are generally being pursued as enhancements to their operations without putting fundamental balance sheet items at risk. **Score: 3**

- **Fundamental credit risk represents the first challenge banks will face in the coming years, particularly under more competitive conditions**. Bulgaria's banks are already under increasing pressure to lend to increase earnings and diversify earnings sources. In this regard, little progress has been made since 1997, as reflected in the aggregate levels of credit in the system. However, what is qualitatively different is that in 1997-98, most of the major problem banks had not yet been privatized. By end 2000, five of six had been privatized, and the remaining public banks were not viewed as threats. In addition, the previous government showed enormous discipline at the macroeconomic level, pursuing a strict currency board arrangement while bringing fiscal deficits down to less than 1 percent of GDP. Thus, the landscape has changed dramatically. On the other hand, even some of the foreign-owned banks have been slow to fully implement their credit risk management systems, partly because they have been sorting out internal operating problems and/or simply becoming more acquainted with the market. Overall, credit risk management will be a formidable challenge in the coming years as banks move into consumer lending, test the leasing market, link their credit offerings to other packages, price aggressively depending on the company and its prospects, and eventually offer unsecured loans.

- **Fundamental issues of secured transactions and contract enforcement need to be resolved for the market to move forward and develop. If this does not happen, desired levels of intermediation will not be achieved**. Security remains weak due to shortcomings in the court system, although the pledge registry appears to be working. The biggest challenge is likely to be the ability to sort out borrowers' management teams, and their ability and willingness to understand requirements on a commercial basis. This includes identification early on of potential violations of loan covenants, the ability to accept increased financial discipline to comply with loan agreements, and general willingness and capacity to work with creditors to abide by contractual agreements. This will require better and timelier information for bankers to manage credit risk on commercial terms. If general movement in this direction is sluggish, bankers will fall back on conservative, low-risk investment strategies, or eventually pull out of the market due to weak earnings.

- **Developments in the nascent mortgage market will need to be scrutinized for underlying asset quality, as well as the use of these assets as collateral for additional exposures and transactions**. There has been some recent movement in the mortgage lending market. This is generally long-term, and risky in both the household and the commercial property development sector unless well-functioning, liquid secondary markets exist. This is not the case today in Bulgaria. However, banks are interested in this market, and this should serve as an additional catalyst to improving collateral legislation and court practices, and accelerating development of long-term financing markets. On the regulatory side, BSD will need to monitor these developments to ensure that banks do not jeopardize the safety of household deposits by making excessively risky property investments or taking on exposure to leverage/securitized ventures that are highly sensitive to pricing fluctuations.

- **Liquidity management has been very prudent and stable in the last few years. However, as the market opens up, banks will need to do more with regard to their liquidity management practices. This also puts the onus on Bulgaria to stimulate development of other credit markets, local capital markets, and other activities so that banks have instruments in which to invest**. Bulgaria's banks are currently very liquid. Liquidity risk is now conservatively managed, with most surplus funds being placed in low-risk paper in offshore banks. This also reflects the relatively unimpressive earnings of the banking system, notwithstanding the low interest rates paid on deposits, the main source of funds. There are reported to be several mismatches and gaps in terms of maturities, currency denomination, and interest rate features (e.g., fixed-variable). However, most of the system is now effectively Euro- or dollar-denominated, thus the system is not exposed to major fluctuations. The high level of conservatism induced by the BNB currency board arrangement (and BSD from a supervisory standpoint) has helped to restore confidence. However, it has also translated into a low interest rate environment, low levels of risk assumption, and relatively low levels of earnings. Until there are further opportunities in the market, banks will likely fall back on their low-risk and relatively effortless investments.

- **Maturity and currency mismatches will likely become more of a challenge in the coming years, particularly as competition heats up and more complex offerings make their way to the market. BSD will need to be up to speed to ensure that market stability is not undermined by these moves**. Banks will be tempted to take advantage of various gaps to increase earnings. While numerous derivatives are available to protect against major risks, there is always temptation to play the odds at the margin for maximum return. Bank management and banking supervision will need to closely monitor investments in instruments with financial structures that are exposed to significant volatility in interest rates, exchange rates, and pricing. This will require banks to have better internal systems. BSD will also need to be able to ensure that bank systems are adequate, which means they will need to be fully apprised of the kinds and complexity of risks banks are taking on. While the task should be reasonably straightforward in Bulgaria, simple fundamentals such as dollar-Euro exposures, fixed-variable interest rate formulas, commodity-based exposures that may be subject to volatile pricing, and features associated with multi-currency investment options will need to be accounted for. There will also be related risks regarding the underlying credit quality of collateral and off-balance sheet items. With the lev fully linked to the Euro, most of the challenge will be more in anticipating potential movements, conducting stress tests to ensure adequate contingencies are in place, and ensuring that major banks do not have consolidated exposures that could cause harm to underlying fundamentals of the inter-bank market and financial system.

- **Basic improvements in MIS, IT and other infrastructure prerequisites for modern**

banking are needed to ensure transactions are honored, contractual agreements are complied with, and the reputation of the Bulgarian financial system as a whole is viewed as sound. Axiomatic as all of this is, many banking systems and supervisory regimes have discovered these weaknesses only in the middle of a crisis, or after material damage has occurred. Some of the key pressure points that will need ongoing monitoring will be (i) the role of large banks in the inter-bank market (as borrowers or lenders); (ii) accurate valuation of assets and liabilities on a consolidated basis; (iii) adequacy of internal controls, accountability, governance and management on a daily basis, with closure of non-real time gaps in core management information flows; (iv) the ability of management to manage on a consolidated basis as banks diversify into new activities and more complex products (e.g., contractual savings, retail lending, leasing, mortgage lending, eventual securitization opportunities, derivatives); (v) the resolution framework for bank failures, and the link to rapid deposit pay-out based on openly disclosed criteria; (vi) contract enforcement, through the courts and other mechanisms; (vii) balancing consumer protection and creditors' rights as banks and other financial services enter the retail product market; and (viii) overall levels of compliance with prudential regulations, and public disclosure of such compliance, to send signals that banks are safe and sound.

- **Political risk abounds in the region, and this will continue to be a challenge for Bulgaria**. This was recently experienced with Kosovo in 1998-99, and the ongoing disruption of regional trade over the years due to problems associated with the former Yugoslavia. More recent skirmishes between Kosovo and FYR Macedonia have shown more needs to be accomplished for the region to become stable. Meanwhile, Bulgaria depends on Russia for significant energy resources. While relations with Russia remain satisfactory, Bulgaria is seeking to join NATO, a move that could harm relations and affect energy supplies and pricing. General energy dependence has also had an affect on the macroeconomic framework, as inflation reached 11.4 percent, more than the 6 percent target Bulgaria had for 2000. This was due to the rise in oil prices in global markets, drought that pushed up food prices, and the appreciation of the US dollar (in which oil prices are denominated) against the DM and Euro (to which the lev is pegged).

- **The crisis in Turkey is not expected to have a serious impact on Bulgaria's economy**. While more than 10 percent of 2000 exports were to Turkey, Bulgaria expects to be able to compensate for declines in these exports. With regard to the financial sector, there are two Turkish banks operating in Bulgaria—Demirbank and Ziraat. Together, they account for about 100 million leva in assets and 40 million leva in deposits. These constitute about 1 percent of total, and thus are not considered likely to undermine financial sector stability in Bulgaria. In fact, because there are such limits to Bulgaria's links to international debt and capital markets, Bulgaria has been shielded from contagion effects since 1998 when emerging market crises have occurred. The major effect tends to be on reduced prices for Bulgaria's Brady bonds.

- **While not a serious risk to the ongoing functioning of the economy, efforts to generate business in less stable environments have proven to have their downside**. There are outstanding obligations from Iraq and Nicaragua that are valued at $1.7 billion, and another $600 million or so from other developing countries. This balance of $2.3 billion is equivalent to nearly 20 percent of 2000 GDP. On a positive note, most of the major claims date back to earlier periods when the state was more directly involved in the economy. In the future, private businesses may assume risk, but this should not have an adverse effect on government and the general functioning of markets in Bulgaria. With regard to banks and credit risk, they will simply need to factor political risk into the overall credit risk evaluation process.

ANNEX 3: A CURSORY COMPARISON OF BULGARIAN BANKING AND FINANCIAL INDICATORS WITH ROMANIA AND POLAND

I. Introductory Country Profiles

I. Introductory Country Profiles	1992	1995	1996	1997	1998	1999	2000
Bulgaria							
Nominal GDP (leva millions)	201	880	1,749	17,055	21,577	22,515	25,587
GDP (millions $)	8,204	13,105	9,831	10,146	12,255	12,404	12,057
GDP per capita ($)	967	1,564	1,179	1,225	1,489	1,513	1,470
Romania							
Nominal GDP (lei billions)	6,029	72,136	108,920	250,480	368,345	521,735	770,000
GDP (millions $)	13,107	27,981	26,994	31,220	33,636	28,580	
GDP per capita ($)	575	1,233	1,194	1,381	1,495	1,276	
Poland							
Nominal GDP (zloty millions)	114,944	288,700	362,800	445,100	549,500	611,600	705,856
GDP (millions $)	71,840	116,977	126,169	126,521	156,821	147,434	
GDP per capita ($)	1,871	3,031	3,269	3,269	4,052	3,810	

COMMENTARY: Bulgaria's overall GDP is smaller than Romania's and Poland's, although the difference in population sizes reflects part of this output differential. GDP per capita varies slightly and favorably when compared with Romania, but clearly is less than the rising per capita incomes registered in Poland. The latter trend has been evident since the mid-1990s, and may reflect the consequences of slow approaches to reform in the first half of the 1990s in Bulgaria and Romania, as opposed to Poland's "shock therapy" and subsequent adjustment after the very early part of the decade. This is partly borne out in the study by Fischer and Sahay ("Taking Stock", *Finance & Development*, September 2000) which shows that Poland's ratio of 1999 output to output recorded one year before the transition began (around 1989) was 28 percent higher, in contrast to these figures being 26 percent lower in Bulgaria and 20 percent lower in Romania. In particular, Bulgaria experienced its lowest growth in 1997, in contrast to Romania and Poland, whose low points were recorded in 1991-92. In Romania's case, it has been slow to reform, whereas Poland has been fairly active with economic reform for nearly a decade. Bulgaria's increase in per capita incomes since the currency board would suggest its approach to reform since 1996-97 has been more effective than what has been accomplished in Romania. However, the amount of time it has taken Poland to achieve favorable indicators also suggests that Bulgaria still requires additional time for reforms to become fully effective and to translate into materially rising purchasing power for the vast majority of its citizens.

II. EBRD Measures (from the 2000 *Transition* Report)

II. EBRD Measures (2000 Transition Report)	**Bulgaria**	**Romania**	**Poland**
Banking Reform & Interest Rate Liberalization	3	3-	3+
Securities Markets & Non-Bank Financial Institutions	2	2	4-
Commercial Law: Extensiveness	4	3+	4-
Commercial Law: Effectiveness	4-	4-	4
Financial Regulations: Extensiveness	3	4	4
Financial Regulations: Effectiveness	2+	3	4

COMMENTARY: Based on EBRD evaluation criteria—these are on a scale of 1 to 4, with "1" being inadequate, "2" being limited in scope and effectiveness, "3" being adequate but in need of refinement and improvement, and "4" being comprehensive, effective, and generally consistent with standards applied in advanced economies—all three countries are roughly equivalent in terms of bank solvency, the framework for banking supervision, interest rate liberalization and preferential (mandated, soft or otherwise) lending, and the participation of private banks and private sector borrowers. The author's view is that this is not correct, and that Poland is more advanced than the other two countries in terms of actual capacity, depth and sophistication. This is mainly because Poland addressed issues earlier on, was open to technical assistance for effective institution building (which strengthened regulatory/supervisory capacity several years in advance of what has been achieved in Bulgaria and Romania), and recognized the need to move to more market-based solutions for competitiveness. Bulgaria is still control/rules-oriented, even though it has clearly merited its rating from EBRD in terms of private participation in the banking sector with its privatization transactions in the last two years. However, Bulgaria and Romania both significantly lag Poland in meeting international standards in capital markets development, and Romania still has to privatize BCR (including what it inherited from Bancorex) and CEC (the former state savings bank). The EBRD has given broadly favorable ratings to all three countries in terms of commercial law. In the case of Bulgaria, this may apply to methodology. However, while laws may be satisfactory, enforcement, judicial understanding, precedent, and general court capacity and administration were not viewed as warranting at 4-. This may be an issue of "efficiency" vs. "effectiveness". However, the legal framework is still considered a problem in Bulgaria due to civil code procedures, weak capacity and training, and corruption and manipulation. Poland and Romania are also reported to have problems in these areas, although Poland has recently adopted legislation that is expected to introduce modernized procedures and practices. In terms of financial regulations, Bulgaria appears to lag both Poland and Romania in terms of coverage and effectiveness of implementation, although the author believes this is not true with regard to Romania. Much of Bulgaria's rating relates to issues of the capital markets and corporate governance, although these are viewed as weak in Romania as well. In terms of effectiveness (coverage), Bulgaria is viewed to significantly lag Poland and to clearly lag Romania. Again, this is not necessarily viewed as accurate in comparison with Romania.

III. Money, Savings and Credit Indicators

III.	Money, Savings and Credit Indicators	1992	1995	1996	1997	1998	1999	2000
	Broad Money/GDP							
	Bulgaria	79.1%	66.4%	74.9%	35.3%	30.6%	32.6%	33.7%
	Romania	30.8%	25.3%	27.9%	24.8%	25.1%	25.7%	
	Poland	35.8%	36.1%	37.2%	39.6%	40.2%	43.1%	
	Year-end base Interest Rate							
	Bulgaria	49.7%	39.8%	435.0%	7.0%	5.2%	4.6%	4.7%
	Romania	70.0%	35.0%	35.0%	40.0%	35.0%	35.0%	
	Poland	>41.4%	29.0%	26.0%	28.0%	15.5%	16.5%	
	Nominal Short-term Credit Rates							
	Bulgaria	64.6%	51.4%	480.8%	13.9%	13.5%	12.4%	12.2%
	Romania	47.5%	53.6%	55.6%	58.9%	62.0%	65.9%	53.5%
	Poland	39.0%	24.0%	20.5%	22.5%	15.5%	14.4%	
	Nominal One-month Time Deposit Rates							
	Bulgaria	45.3%	25.3%	211.8%	3.0%	3.3%	3.2%	3.3%
	Romania	32.4%	38.9%	34.1%	42.3%	41.3%	45.4%	32.7%
	Poland	32.0%	19.5%	17.0%	18.0%	11.0%	7.5%	
	Net Spreads on Nominal Bank Rates							
	Bulgaria	19.3%	26.1%	269.0%	10.9%	10.2%	9.2%	8.9%
	Romania	15.1%	14.7%	21.5%	16.6%	20.7%	20.4%	20.8%
	Poland	7.0%	4.5%	3.5%	4.5%	4.5%	6.9%	

COMMENTARY: Broad money has begun to increase in Bulgaria as a percent of GDP after collapsing in 1996-97. The steady rise with stabilization is similar to trends in Poland, which has also shown a gradual and increasing rise as real GDP growth has been sustained, confidence in banking institutions increases, and banks expand with retail and corporate services. Meanwhile, Romania's trends are less favorable, indicating less confidence in the banks and the economy. However, trends in Bulgaria should not be oversold. Broad money-to-GDP is still less than half the level achieved through 1996, and they remain very low by developed market standards. Even when compared with other EU accession candidate countries, Bulgaria lags most (apart from Latvia, Lithuania and Romania). Year-end base rates have shown considerable advantage in Bulgaria as a benefit derived from macroeconomic stabilization, having declined dramatically. Bulgaria's rates are lower than in Poland and Romania. However, low interest rates alone are not sufficient to energize an economy, as shown in Japan. Net spreads on nominal bank rates show Bulgaria approaching Poland in the narrowing of spreads, partly due to intensified competition in the corporate sector. These rates have been fairly steady since 1997, and shown very slight declines each year since then, including in 2000. However, unlike Poland, Bulgarian banks are paying negative real rates on deposits. This does not bode well for deposit mobilization efforts, although this should be corrected in the coming years as Bulgarian banks compete for a larger share of a growing consumer markets, and to expand their retail base of funding. Meanwhile, net spreads remain very high in Romania, more than double those in Bulgaria. Poland's net spreads are lower than in Bulgaria, but the gap is about 2 percent, far less than the gap relative to Romania.

IV. Macroeconomic Performance Indicators

IV.	Macroeconomic Performance Indicators	1992	1995	1996	1997	1998	1999	2000
	Real GDP							
	Bulgaria	-7.3%	2.1%	-10.9%	-6.9%	3.5%	2.4%	5.6%
	Romania	-8.8%	7.1%	3.9%	-6.1%	-5.4%	-3.2%	1.5%
	Poland	2.6%	7.0%	6.1%	6.9%	4.8%	4.1%	5.0%
	Total CEE and Baltics	-3.2%	5.4%	4.1%	3.6%	2.6%	2.1%	4.1%
	Inflation Rate							
	Bulgaria	82.0%	62.0%	123.0%	1082.0%	22.2%	0.7%	11.4%
	Romania	210.0%	32.3%	38.8%	154.0%	59.1%	45.8%	45.0%
	Poland	43.0%	27.8%	19.9%	14.9%	11.8%	7.3%	9.9%
	Total CEE and Baltics (unweighted average)	476.0%	23.3%	24.1%	105.0%	13.7%	7.1%	9.1%
	Fiscal Balance/GDP							
	Bulgaria	-2.9%	-5.7%	-10.4%	-2.1%	0.9%	-0.9%	0.4%
	Romania	-4.6%	-2.5%	-3.9%	-4.6%	-5.0%	-3.5%	-4.0%
	Poland	-4.9%	-3.1%	-3.3%	-3.1%	-3.2%	-3.3%	-3.0%
	Total CEE and Baltics	-7.1%	-3.2%	-3.7%	-3.0%	-3.1%	-4.3%	-3.3%
	Current Account Balance/GDP							
	Bulgaria	-4.2%	-0.2%	0.2%	4.2%	-0.5%	-5.5%	-5.8%
	Romania	-8.0%	-6.3%	-8.9%	-6.8%	-7.0%	-3.8%	-4.9%
	Poland	1.1%	4.5%	-1.0%	-3.2%	-4.4%	-7.6%	-7.1%
	Total CEE and Baltics	-8.6%	-3.3%	-5.9%	-6.4%	-6.4%	-6.1%	-5.8%
	Net Foreign Direct Investment (US$ millions)							
	Bulgaria	42	98	138	507	537	806	975
	Romania	73	417	415	1,267	2,079	949	500
	Poland	284	1,134	2,741	3,041	4,966	6,642	10,000
	Total CEE and Baltics	3,098	9,673	8,202	9,500	15,198	18,086	22,787

COMMENTARY: Bulgaria's macroeconomic fundamentals have improved since 1997 in most cases. Real GDP has increased for three years, and has exceeded the average for CEE and the Baltic states (the non-CIS transition countries) for those three years. While Bulgaria's figures have not been as impressive as Poland's long running real GDP growth rates, it has performed better than Romania in recent years. Bulgaria's real GDP growth in 2000 also exceeded Poland's for the first time in a decade. The inflation rate increased in 2000, as it did just about everywhere in the region, but has come down from hyperinflationary levels in 1996-early 1997. Nevertheless, Bulgaria experienced double-digit inflation, and this was higher than the norm for the region by 2.3 percent. Efforts to bring this rate down may have a dampening effect on economic growth. Moreover, given Bulgaria's previous years' performance, there has been little consistency with regard to inflation rates. This volatility can serve as a disincentive to investment, notwithstanding the leva link to the Euro through the currency board arrangement. Fiscal deficits have been brought under control with strict discipline, and performance on this front has been about the best in the region. There is a possibility of some fiscal loosening with the new government's proposal to increase public sector wages and pensions, and if there is a tightening of monetary policy to rein in the inflation rate. However, overall, Bulgaria has shown a high level of fiscal discipline in recent years. The statistics suggest there may be some room for such loosening on the condition that efforts continue to broaden the fiscal base and to stimulate job-creating investment. While current account deficits have increased since 1999, they remain on par with the region as countries re-tool to be more competitive. As an example, Poland (a first-tier EU accession candidate) experienced current account deficits exceeding 7 percent the last two years. Bulgaria's deficits have likewise been high, averaging nearly 6 percent over the last two years. By traditional measures, these are fairly high figures that will need to be monitored. However, much of the import bill is expected to translate into higher productivity and export earnings. As for foreign direct investment, Bulgaria remains small as a percentage of the regional total, and far less than Poland and Romania. However, Bulgaria's trends are favorable, having achieved nearly $1 billion in FDI in 2000. Plans to improve the business environment and develop the high tech sector should help in this regard. Overall, Bulgaria's macroeconomic indicators are broadly favorable, and generally in line with or outperforming regional standards.

V. Bank Ownership Profile

V. Bank Ownership Profile	1992	1995	1996	1997	1998	1999	2000
Number of Banks							
Bulgaria	79	41	42	28	33	35	35
Romania		24	31	33	36	34	
Poland		81	81	83	83	77	
Foreign-owned Banks							
Bulgaria	0	3	3	7			>20
Romania		6	8	13	16	19	
Poland		18	25	29	31	39	
Asset Share of State Banks							
Bulgaria			82.2%	66.0%			20.0%
Romania		84.3%	80.9%	80.0%	75.3%	50.3%	
Poland		71.7%	69.8%	51.6%	48.0%	25.0%	

COMMENTARY: Bulgaria experienced regulatory-driven consolidation during the early 1990s, ultimately facing a crisis in the mid-1990s in which about one third of banks had to be closed down. The remaining banks had to be privatized to restore the system's ability to function under stable conditions. Bulgaria has essentially reached that point on the basis of solvency and liquidity ratios. Bulgaria has also achieved major success with the privatization of banks via strategic foreign investment, a policy pursued in the region by Hungary, and subsequently adopted by Poland, the Czech and Slovak Republics, Croatia, the Baltic states, and several of the countries in the Balkans. The ownership trend towards an increasingly prominent role for foreign banks shows up in the table, with more than 20 of Bulgaria's 35 banks under foreign control. This is in stark contrast to 1996, when there were only three foreign banks, and when the state controlled more than 80 percent of banking system assets. Recent year indicators are broadly consistent with Poland, which has also accelerated the role of strategic foreign investment in the banking sector in recent years, and compare favorably with ownership trends in Romania, where four state banks still account for about half of system assets. Bulgaria and Poland are very similar as well with regard to the remaining banks in state hands. In Bulgaria, there are four, of which two are the former state savings bank and the bank focused on agricultural finance. In Poland, the two large banks remaining to be privatized have traditionally been in local currency savings and agricultural finance. Romania has also recently announced the privatization of its agricultural bank, and is preparing for the privatization of one other major bank, which would leave only two other banks (including the state savings bank) under state control. The privatization of Bank Agricola would bring the total to three state banks accounting for about one third of total assets. The second privatization (that of BCR) would bring Romania's state bank share to a small portion of total system assets.

VI. Bank Lending Profile

VI.	Bank Lending Profile	1992	1995	1996	1997	1998	1999	2000
	Domestic Credit to Enterprises/GDP							
	Bulgaria	5.5%	21.1%	35.6%	12.6%	12.7%	14.6%	16.2%
	Romania			11.5%	13.7%	15.2%	10.5%	
	Poland	11.4%	12.7%	15.9%	17.1%	17.6%	18.8%	
	Bad Loans/Total Loans							
	Bulgaria		12.6%	14.6%	12.9%			8.2%
	Romania		37.9%	48.0%	56.5%	67.5%	36.6%	
	Poland		23.9%	14.7%	11.5%	11.8%	14.5%	
	Net Domestic Credit/GDP							
	Bulgaria	85.1%	58.3%	65.9%	6.8%	6.1%	6.0%	6.2%
	o/w claims on Gov't	44.3%	30.6%	51.6%	9.6%	2.4%	0.7%	1.9%
	o/w claims on SOEs	67.2%	19.2%	30.0%	7.4%	4.4%	3.2%	1.6%
	o/w claims on Private	9.0%	21.6%	36.9%	13.1%	12.8%	15.0%	14.6%
	Romania		24.9%	28.6%	18.0%	20.0%	15.9%	
	o/w claims on Gov't		2.5%	5.0%	4.4%	5.1%	5.7%	
	o/w claims on SOEs		22.3%	12.1%	5.1%	3.2%	1.8%	
	o/w claims on Private			11.5%	8.4%	11.7%	8.4%	
	Poland		33.4%	36.2%	36.3%	36.3%	39.9%	
	o/w claims on Gov't		13.6%	13.7%	11.8%	10.9%	11.0%	
	o/w claims on SOEs		7.0%	6.6%	6.5%	5.7%	5.2%	
	o/w claims on Private		12.7%	15.9%	18.1%	19.7%	23.8%	

COMMENTARY: Bulgaria's lending has declined since 1996 after the economic collapse. However, the amount of credit allocated to enterprises (including households in Bulgaria's case) relative to GDP is not altogether different from several countries in the region. It is lower than in Poland, which experienced increases in net lending to the real sector starting in late 1995, but is higher than in Romania. In contrast to the mid-1990s, Bulgaria's loan portfolio is now of higher quality than in the mid-1990s. Thus, while lending remains relatively low, high levels of capital (relative to risk-weighted assets) and a higher proportion of standard (performing) loans reflect increased capacity in the banking system for risk-taking. This will occur in Bulgaria, as it did in Poland, as the economy grows and competition in the banking sector heats up. These developments are favorable when compared with Romania, where bad loans have been a serious problem. Meanwhile, there has been a clear shift in lending to the private sector and away from exposures to state enterprises in all three countries. On this note, Bulgaria has provided even less financing to government and state enterprises than the other two countries. This is largely the result of the currency board arrangement and strict prudential regulations.

VII. Deposit Mobilization

VII.	Bank Deposit Mobilization	1995	1996	1997	1998	1999	2000
	Deposits						
	Bulgaria (millions of leva)	509	1,114	4,216	4,429	4,956	7,116
	o/w Demand Deposits	46	110	945	1,014	1,039	
	o/w Time/Savings Deposits/Foreign Currency	463	1,004	3,271	3,415	3,917	
	Romania (billions of lei)	14,343	24,933	52,946	81,005	116,743	127,059
	o/w Demand Deposits	3,007	5,366	8,742	9,590	11,059	9,531
	o/w Time/Savings Deposits	7,383	12,481	26,523	41,213	55,211	59,858
	o/w Foreign Currency Deposits	3,953	7,086	17,681	30,202	50,473	57,670
	Poland (millions of zlotys)	84,730	112,888	145,509	190,542	225,272	249,781
	o/w Demand Deposits	17,817	28,702	34,425	41,438	49,970	50,249
	o/w Time/Savings Deposits/Foreign Currency	66,913	84,186	111,084	149,104	175,302	199,532
	Deposits/GDP						
	Bulgaria	57.8%	63.7%	24.7%	20.5%	22.0%	27.8%
	o/w Demand Deposits	5.2%	6.3%	5.5%	4.7%	4.6%	
	o/w Time/Savings Deposits/Foreign Currency	52.6%	57.4%	19.2%	15.8%	17.4%	
	Romania	19.9%	22.9%	21.1%	22.0%	22.4%	16.5%
	o/w Demand Deposits	4.2%	4.9%	3.5%	2.6%	2.1%	1.2%
	o/w Time/Savings Deposits	10.2%	11.5%	10.6%	11.2%	10.6%	7.8%
	o/w Foreign Currency Deposits	5.5%	6.5%	7.1%	8.2%	9.7%	7.5%
	Poland	29.3%	31.1%	32.7%	34.7%	36.8%	35.4%
	o/w Demand Deposits	6.2%	7.9%	7.7%	7.5%	8.2%	7.1%
	o/w Time/Savings Deposits/Foreign Currency	23.2%	23.2%	25.0%	27.1%	28.7%	28.3%

COMMENTARY: Bulgaria has increased its deposit base since major depletion occurred in 1996-early 1997. However, deposit levels remain relatively low, as in Romania, and still significantly lag levels achieved in Poland when measured against GDP. Part of the reason for the superior performance of Poland is that banks have made a stronger effort at the retail level to attract deposits in recent years. This process is only beginning in a competitive way in Bulgaria (and has yet to really occur in Romania). However, in Bulgaria, there are reasons for optimism that deposit mobilization will increase in the coming years. These include increasing competition among banks for the developing retail/consumer market, reduced tax rates for small businesses and households (that are expected to increase compliance, broaden the base and increase revenues), and conversion to the Euro on January 1, 2002 which will serve as an incentive for people to convert their DM holdings through the banking system. However, per capita incomes are lower in Bulgaria than in Poland, and hard budget constraints have served as an incentive for households and enterprises to keep cash on hand to effect transactions. Until this changes, there may be less incentive for households and firms to place deposits with banks. Negative real rates paid on deposits also serve as a disincentive. Elsewhere (including in Poland), the market has shown responsiveness when banks have increased real rates paid on deposits. Transition countries have frequently shown that people are looking to place surplus cash in financial instruments, even simple instruments such as bank savings/time deposits.

ANNEX 4: LIST OF CONTACTS

Pavlina Anatchkova, Bulgarian National Bank, Director

Anatoli Belchev, Deloitte & Touche, Manager

Michael Carlton, KPMG Barents Group, Senior Advisor to the Bulgarian National Bank

Rosa Chiappe, Carana Corporation, Chief of Party (for USAID Pension Reform Project)

Jordan Chouckov, Insurance Supervision Directorate, Head

Donald Crane, USAID Capital Markets Regulation Project, Chief of Party

Ronald C.C. Cuming, University of Saskatchewan

Damyan Damyanov, United Bulgarian Bank, Manager

Borislava Drunkova, Price Waterhouse Coopers, Financial Advisory Services

Christoph Freytag, IPC, Chief of Party for Micro-lending

Kiril Georgiev, Citibank, Treasurer

Stanislav Georgiev, Bulbank, Head of Finance and Planning

Maria Georgieva, International Banking Institute, Director

Alina Grigorova, United Bulgarian Bank, Bank Officer

Elvin Guri, European Bank for Reconstruction and Development, Associate Banker

Hermann Hagspiel, European Union, Advisor

John Harris, Raiffeisen Bank, Chairman

Allan Hawkins, Barents Group, Adviser to the Bank Consolidation Company

Thomas Higgins, Bulgarian American Enterprise Fund, Chief Investment Officer and Managing Director

Simon Holmes, Deloitte & Touche, Director

Stella Ilieva, World Bank, Research Analyst

Venislav Iotov, AIG Bulgaria, General Manager

Christo Ivanov, American Bar Association—Central and East European Law Initiative, Legal Advisor

Lori Kunze, Catholic Relief Services, Country Representative

Richard Lewis, KPMG Barents Group Consulting, Senior Advisor

Stoyan Manolov, Bulgarian National Bank, Director, Off-site Supervision and Analyses

Albena Markova, Price Waterhouse Coopers, Manager

Roumyana Markova, Deposit Insurance Fund, International Cooperation and Public Relations

Mileti Mladenov, Deposit Insurance Fund, Chairman of the Management Board

Nickolay Nickolov, Insurance Supervision Department, Head

Emily Palakartcheva, Bulecoproject, Partner and General Manager

Asparouh Panayotov, BNP Paribas, Head of Financial and Economic Research

Ivana Petkova, Institute for Economic Policy, Director

Tatyana Petrova, Bulgarian National Bank, Director, On-site Inspection

Georgy Pirkov, Insurance Supervision Agency, Head of Financial Supervision Division

Peter Rolls, ING Bank, Country Manager

James Rives, KPMG Barents Group, Director (Chief of Party for USAID Banking Supervision Project)

Donna Rose, KPMG Barents Group, Senior Advisor to the Bulgarian National Bank

Ullrich Schubert, BNP Paribas, Chief Executive Officer

Peter Stella, International Monetary Fund, Resident Representative

Lada Stoyanova, World Bank, Deputy Resident Representative

Stephen Strauss, International Commercial Bank, Chief Executive Officer

Christopher Thompson, KPMG Barents Group, Legal Adviser

Marin Todorov, Bulecoproject, Managing Partner

Sheila Tschinkel, U.S. Treasury, Advisor to Ministry of Finance and Bulgarian National Bank

Ann Wallace, FMI Inc., Chief of Party (for USAID Capital Markets Regulation Project)

Oliver Whittle, Bulgarian Post Bank, Executive Director

Martin Zaimov, Bulgarian National Bank, Deputy Governor

Raihan Zamil, KPMG Barents Group, Senior Advisor to the Bulgarian National Bank

ANNEX 5: BIBLIOGRAPHY

"An Assessment and Rating of the Bulgarian Banking System", Michael Borish and Company, Inc., April 1998.

"Annual Report", Bulbank, 2000

"Annual Report", Deposit Insurance Fund, 1999.

"Annual Report", Insurance Supervision Directorate, 1999.

"Annual Report", United Bulgarian Bank, 2000

"Banking Laws and Regulations," Bulgarian National Bank, 1998.

"Bulgaria: 2000 Article IV Consultation and Fifth Review Under the Extended Arrangement", International Monetary Fund, March 2001.

"Bulgaria: 2001", Merrill Lynch, March 6, 2001.

"Bulgaria: Selected Issues and Statistical Appendix", International Monetary Fund, March 2001.

"Commercial Banks in Bulgaria", Bulgarian National Bank, December 2000.

Country Economic Memorandum, World Bank, 2000.

Demirguc-Kunt, Asli and Tolga Sobaci, "Deposit Insurance Around the World: A Data Base", World Bank, May 1, 2000.

"Early Warning Report", UNDP, March 2001.

"Emerging Market Banks Around Europe Lure Investors", Standard & Poor's, June 30, 2000.

"Employment, Skills and Transition", European Bank for Reconstruction and Development, London, 2000.

"Enterprise Performance and Growth", European Bank for Reconstruction and Development, London, 1997.

Fischer, Stanley and Ratna Sahay, "Taking Stock", *Finance & Development*, September 2000.

International Financial Statistics, International Monetary Fund, November 2000.

"Investment Guide for Southeast Europe", www.seeurope.net

"Rating the Transition Economies—2001", Standard & Poor's, April 16, 2001.

"Real Time Gross Settlement System in the BNB—Terms of Reference", Bulgarian National Bank, 2000.

"Report on the Observance of Standards and Codes", International Monetary Fund, March 2000.

"The Bulgarian Pension Model", USAID, 2000.

"The Bulgarian Pension Model: One Year After the Start", USAID, 2001.

The Sofia Echo, April 26–May 3, 2001.
------------------, May 4-10, 2001.

"The Insurance Industry and Insurance Supervision in Bulgaria," (draft report to the World Bank), Lawrie Savage & Associates, December 29, 2000.

"The Shadow Economy in Bulgaria", Harvard University, Agency for Economic Analysis and Forecasting, and the Institute for Market Economics, Sofia, October 2000.

Ulgenerk, Esen and Leila Zlaoui, "From Transition to Accession", World Bank Technical Paper No. 473, 2000

White Paper on Foreign Investment in Bulgaria and *Government of Bulgaria Response to the White Paper*, Bulgarian International Business Association, www.biba.mobikom.com, 2000.

World Economic Outlook, International Monetary Fund, October 2000.

Yonkova, Assenka, "Banking Sector: Bulgaria 2000", IME, 2000.

www.asme.bg

www.bnb.org

www.bse-sofia.bg

www.fitchibca.org

www.imf.org

www.moodys.com

www.standardandpoors.com

www.worldbank.org